Current Federal Tax Developments

(CFTD)

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Consolidated Appropriations Act: Individual Provisions

LEARNING OBJECTIVES

When you have completed this unit, you will be able to

- **Advise** clients on their qualification for the second round of recovery credit rebate checks and compute the amount the client is eligible to receive

- **Apply** the rules for the revisions to above the line deductions for charitable contributions and educator expenses found in this Act

A number of individual provisions were contained in the various bills making up the year-end package of bills.

CHARITABLE TAX PROVISIONS

For charitable issues, Congress mainly extended CARES items that were only to apply to 2020 to now carry into 2021, though for the above-the-line deduction for charitable contributions, Congress made some interesting modifications to the item.

Charitable Deduction for Non-Itemizers Extended to Cover 2021

In the CARES Act, Congress added a provision that allowed taxpayers a $300 above the line deduction for charitable contributions if the taxpayer did not itemize deductions in 2020. The IRS, per the draft Form 1040 instructions, interpreted this rule to mean that even those filing a joint tax return would only qualify for a single $300 above-the-line deduction.

In this Act, Congress has decided to extend the deduction for one more year and allow joint filers to claim a $600 deduction—but that increase only applies to the 2021 tax year. The law provides:

> In the case of any taxable year beginning in 2021, if the individual does not elect to itemize deductions for such taxable year, the deduction under this section shall be equal to the deduction, not in excess of $300 ($600 in the case of a joint return), which would be determined under this section if the only charitable contributions taken into account in determining such deduction were contributions made in cash during such taxable year…[1]

However, such deductions cannot be made to

- An IRC §509(a)(3) supporting organization or
- For the establishment of a new, or maintenance of an existing, donor-advised fund.[2]

Apparently concerned that many taxpayers will use this provision to claim charitable deductions they did not actually make, Congress has raised the understatement penalty to 50% for an overstatement of this above-the-line deduction. The 50% penalty will be applied to the portion of the understatement of tax on the return related to the overstatement of this above-the-line deduction.[3]

The special 50% underpayment penalty under this provision is also exempted from the supervisory approval of the assessment of the penalty under IRC §6751(b)(2)(A).[4]

The rule only applies to tax years beginning in 2021.[5]

Increased Charitable Contributions Provisions Continued into 2021

Under the CARES Act cash charitable contributions of an individual were not subject to the 60% of adjusted gross income limits that normally apply to such contributions and the corporate contribution of food inventory limit was raised to 25% of taxable income from 15%. In both cases, these changes only applied to contributions made during 2020.

[1] IRC §170(p) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §212(a)

[2] IRC §170(p)(1) and (2) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §212(a)

[3] IRC §6662(b)(8) and (l) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §212(b)(1) and (2)

[4] IRC §6751(b)(2)(A) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §212(b)(3)

[5] IRC §170(p) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §212(a)

The Act continues this provision into 2021 but makes no other changes to these provisions.[6]

OTHER INDIVIDUAL TAX PROVISIONS

The bills contain a number of other provisions that impact individuals.

Educator Expense Deduction Includes Payments for Personal Protective Equipment

The IRS is directed to provide regulations or other guidance clarifying that the payment by a qualified educator for personal protective equipment, disinfectant, and other supplies used for the prevention of the spread of COVID-19 qualify for the above-the-line deduction of an educator's expenses under IRC §62(a)(2)(D)(ii). This rule will apply for expenses paid or incurred after March 12, 2020.[7]

Exclusion from Income for Students Receiving Qualified Emergency Financial Aid Grant

In the case of a student receiving a qualified emergency financial aid grant:

- Such grant shall not be included in the gross income of such individual for purposes of the Internal Revenue Code of 1986, and
- Such grant shall not be treated for purposes of the American Opportunity or Lifetime Learning Credit as
  - A qualified scholarship, which is excludable from gross income under section 117,
  - An educational assistance allowance under chapter 30, 31, 32, 34, or 35 of title 38, United States Code, or under chapter 1606 of title 10, United States Code, and
  - A payment for such individual's educational expenses, or attributable to such individual's enrollment at an eligible educational institution, which is excludable from gross income under any law of the United States.[8]

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[6] Taxpayer Certainty and Disaster Relief Act of 2020 §213(a)

[7] COVID-related Tax Relief Act of 2020 §275

[8] COVID-related Tax Relief Act of 2020 §277

Credit for Sick Leave and Family Leave of Self-Employed Individuals

The credits for sick leave and family leave for self-employed individuals are extended through March 31, 2021. Now the credits are available if the self-employed person:

- Would be entitled to paid leave during the taxable year pursuant to the Emergency Paid Sick Leave Act if the individual were an employee of an employer (other than him/herself) or
- Would be so entitled if that mandate applied through March 31, 2021.[9]

As well, if a self-employed taxpayer so elects, the taxpayer may elect to use the prior year rather than the current year for purposes of the credits for paid sick and family leave.[10]

[9] COVID-related Tax Relief Act of 2020 §286(a)(2) and (4)
[10] COVID-related Tax Relief Act of 2020 §287

Unit

2

Consolidated Appropriations Act: Business COVID-Related Relief

LEARNING OBJECTIVES

When you have completed this unit, you will be able to

› **Explain** the differences between the 2020 (as revised) and 2021 employee retention credits and advise clients on taking advantage of the credit

› **Advise** clients on the types of food and beverage expenditures that will qualify for a 100% deduction in 2020 and 2021

› **Apply** the special rules on the taxability of amounts received under various CARES Act programs

The *Consolidated Appropriations Act, 2021* contains a number of provisions meant to provide relief to businesses impacted by the COVID-19 pandemic.

PAYROLL TAX CREDIT REVISIONS

Congress extended and revised the key payroll tax credits found in the *Families First Coronavirus Relief Act* and the CARES Act. Basically, these changes result in:

- A somewhat revised employee retention credit (ERC) that will apply for 2020 wages and for which employers may still qualify to claim even if they received a PPP loan;
- A more heavily revised version of the ERC that will apply to wages paid in the first six months of 2021;

- An extension of the credit to employers to pay for leave provided for under the Families First Coronavirus Relief Act but no longer is the employer required to offer such leave; and

- Allowing employee payroll taxes deferred from paychecks issued between September 1, 2020 and December 31, 2020 to be repaid through the end of 2021 rather than just the first four months.

CLARIFICATIONS AND TECHNICAL IMPROVEMENTS TO CARES ACT EMPLOYEE RETENTION CREDIT EFFECTIVE RETROACTIVE TO ENACTMENT OF CARES ACT (THE 2020 ERC CHANGES)

The *Taxpayer Certainty and Disaster Relief Act of 2020* contains a number of significant changes to the employee retention credit (ERC) found at §2301 of the CARES Act, which have retroactive effect, along with a second set that apply for wages paid in 2021. The revisions below, found in §206 of the Act, will apply to 2020 wages (and will continue on along with other changes for 2021 wages).

Gross Receipts for a Tax Exempt Organization

The revision clarifies that gross receipts for a tax-exempt organization for the credit will be determined by reference to gross receipts within the meaning of IRC §6033, which is the IRC provision governing returns filed by such exempt organizations.[11]

Health Care Costs

The new law rearranges the definitions, treating health care costs as wages, making it clear that such payments by themselves would represent wages even if an employee was not otherwise currently employed by the employer.[12]

Availability for Employers That Obtained PPP and/or PPP2 Loan

The major change found in the "clarifications and technical improvements" section of the law relates to the interaction of the Paycheck Protection Program (PPP) loans and the ERC. Under the CARES Act, employers who received a Paycheck Protection Program loan were barred from claiming the ERC. Congress has decided to simply block the ability for an employer to both claim the ERC on a payment to the employee and use that same payment as part of the wages used to claim forgiveness of the PPP2 loan.

[11] Taxpayer Certainty and Disaster Relief Act of 2020 §206(a)

[12] Taxpayer Certainty and Disaster Relief Act of 2020 §206(b)

Congress has removed the provision in the CARES Act that barred an employer who received a Paycheck Protection Program loan from claiming the employee retention credit.[13]

The law provides that any amounts used to claim an ERC cannot be used as payroll costs when claiming forgiveness for either the PPP or PPP2 loan.[14]

In order to enable a business to coordinate between the PPP loan forgiveness and the ERC, the law provides that an employer will be able to elect not to take into account a portion of the wages paid that otherwise would qualify for ERC credit in computing the credit. The law provides that the IRS can prescribe how and when this election is to be made.[15]

As well, the provision provides:

> The Secretary, in consultation with the Administrator of the Small Business Administration, shall issue guidance providing that payroll costs paid during the covered period shall not fail to be treated as qualified wages under this section by reason of an election under paragraph (1) to the extent that a covered loan of the eligible employer is not forgiven by reason of a decision under section 7A(g) of the Small Business Act. Terms used in the preceding sentence, which are also used in section 7A of the Small Business Act shall have the same meaning as when used in such section.[16]

The *Taxpayer Certainty and Disaster Relief Act of 2020* authorizes the IRS to write regulations "to prevent the avoidance of the purposes of the limitations under this section, including through the leaseback of employees."[17]

Provisions in This Section Retroactive to Enactment of CARES Act

These changes are effective as if they had been part of the original CARES Act.[18] This means that many taxpayers who received a PPP loan now will be able to claim an ERC credit for wages paid in 2020.

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[13] Removal of CARES Act §2301(j) by Taxpayer Certainty and Disaster Relief Act of 2020 §206(c)(2)

[14] Taxpayer Certainty and Disaster Relief Act of 2020 §206(c)(1) revising SBA §7A(a)(12)

[15] CARES Act §2301(g)(1) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §206(c)(2)(A)

[16] CARES Act §2301(g)(2) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §206(c)(2)(A)

[17] Taxpayer Certainty and Disaster Relief Act of 2020 §206(d)

[18] Taxpayer Certainty and Disaster Relief Act of 2020 §206(e)(1)

To reduce the additional work involved with amending multiple forms 941 from 2020, the Act provides for an election by an employer to claim the credit on its next filed Form 941:

> For purposes of section 2301 of the CARES Act, an employer who has filed a return of tax with respect to applicable employment taxes (as defined in section 2301(c)(1) of division A of such Act) before the date of the enactment of this Act may elect (in such manner as the Secretary of the Treasury (or the Secretary's delegate) shall prescribe) to treat any applicable amount as an amount paid in the calendar quarter which includes the date of the enactment of this Act.[19]

The *applicable amount* to be claimed as a payment on the next filed Form 941 is defined as the amount of wages which are:

- Defined as wages for purposes of ERC or
- Permitted to be treated as qualified wages under guidance issued pursuant to the regulations allowing wages to be treated as qualified for ERC when PPP loan forgiveness is not obtained as described earlier.[20]

And those wages were:

- Paid in a calendar quarter beginning after December 31, 2019 and before October 1, 2020 and
- Were not taken into account by the taxpayer in calculating the ERC credit for such calendar quarter.[21]

Extension and Modifications of Employee Retention and Rehiring Tax Credit First Effective in 2021

The second set of revisions to the original ERC do not take effect until 2021. Note that these apply *in addition* to the modifications that took effect in 2020 that were part of §206 of this Act.

Extension of ERC Program into First Half of 2021

First, the ending date for the ERC is pushed forward from the fourth quarter of 2020 to the second quarter of 2021.[22]

[19] Taxpayer Certainty and Disaster Relief Act of 2020 §206(e)(2)(A)

[20] Taxpayer Certainty and Disaster Relief Act of 2020 §206(e)(2)(B)

[21] Taxpayer Certainty and Disaster Relief Act of 2020 §206(e)(2)(B)

[22] CARES Act §2301(m) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §207(a)(1)

Increase in the Credit Percentage

The amount of the credit is also increased from 50% of qualified wages paid to 70% of qualified wages paid beginning with the first quarter of 2021.[23]

$10,000 per Employee Test Applied on a Per-Quarter Basis

In 2021, the per employee wage limit also is modified, no longer limiting the qualified wages per employee to $10,000 over the lifetime of the ERC to $10,000 per quarter that the ERC is claimed.[24]

80% Test for Substantial Reduction in Gross Receipts

The revisions effective in 2021 also make it easier for a taxpayer to qualify for the credit based on a reduction in revenue for a quarter. Under the 2020 version of the ERC, a taxpayer had to show a decrease below 50% of revenue for the same quarter in 2019. In the new version, a quarter where revenue is less than 80% of the revenue for the same quarter in 2019 will begin to qualify a taxpayer for the credit.

However, now each quarter is tested on its own. The prior rule provided that the credit applied until the first quarter *after* the taxpayer's revenues (computed under the rules for §448(c)) were more than 80% of the same period in 2019.[25]

Employers Not in Existence in 2019

If an employer was not in existence in 2019, the following special rule applies:

> With respect to any employer for any calendar quarter, if such employer was not in existence as of the beginning of the same calendar quarter in calendar year 2019, clause (ii)(II) shall be applied by substituting '2020' for '2019'.[26]

Essentially, such taxpayers will begin comparing the quarter in 2021 vs. the quarter in 2020.

[23] CARES Act §2301(a) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §207(b)
[24] CARES Act §2301(b)(1) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §207(c)
[25] CARES Act §2301(c)(2)(A)(ii)(II) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §207(d)(1)(A)
[26] CARES Act §2301(c)(2)(A) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §207(d)(1)(B)

Election to Use Prior Quarter for Revenue Testing

The revised ERC also contains the option to allow an employer to elect to test the decrease in revenue based upon the preceding rather than current calendar quarter.[27] Nothing in the section forces a taxpayer to use this election for both quarters, so it seems to allow the taxpayer the "extra" quarter that resulted from the 2020 ERC rule that allowed a taxpayer to keep using the credit until the quarter after the taxpayer exceeded 80% of revenues in the same quarter in 2019.

The effect of this, though, would be to limit the ability of a taxpayer that had exceeded 80% of 2019's revenue for the fourth quarter in the fourth quarter of 2020 to continue to use the credit unless that taxpayer's first quarter 2021 revenue was less than 80% of the first quarter of 2019.

Certain Governmental Entities Qualify for ERC

While CARES Act §2301(f) still generally bars governmental entities from receiving the ERC, the new law provides a list of certain governmental entities that will be allowed to receive the ERC in 2021 if they otherwise qualify.

These governmental entities include:

- Any §501(c)(3) organization exempt from tax under IRC §501(a);
- A college or university; and
- An entity where the principal purpose or function of the entity is providing medical or hospital care.[28]

Changes to Computation of Qualified Wages (Increase in Small Business Employee Limit)

The Act revises the definition of a large employer by raising the number of employees from 100 to 500.[29] Thus, more employers will be able to claim the ERC for wages paid to employees who are performing services for the employer during the periods the employer qualifies for the credit, rather than, as a large employer, only being able to claim the credit for amounts paid to employees performing no services for the employer.

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[27] CARES Act §2301(c)(2)(B) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §207(d)(2)(A)
[28] CARES Act §2301(f)(2) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §207(d)(3)
[29] CARES Act §2301(c)(3)(A) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §207(e)(1)

The Act also removes the original limitation that provided that qualified wages for an employee could not exceed the amount the employee would have been paid for working an equivalent duration during the 30 days immediately preceding the period.[30]

Double Benefit Rule Simplified

The Act removes two provisions that 1) denied any credit for any quarter in which the employer claimed the work opportunity credit under IRC §51 and 2) prohibited taking a credit under §45S (credit for paid family or medical leave) for any wages on which the ERC was claimed. They are replaced with a single, broader bar on claiming a double benefit.

Any wages taken into account in determining the ERC may not be taken into account in computing a credit under:

- IRC §41 (Credit for increasing research activities);
- IRC §45A (Indian employment credit);
- IRC §45P (Employer wage credit for employees who are active duty members of the uniformed services);
- IRC §45S (Employer credit for paid family and medical leave);
- IRC §51 (Work opportunity credit); and
- IRC §1396 (Empowerment zone employment credit).[31]

Advance Payment of Employee Retention Credit

A new provision has been added to the ERC by the Act allowing small employers to elect to obtain an advance payment of the ERC. For these purposes a small employer is one who did not employ more than 500 employees in 2019—larger employers are barred from receiving such payments.[32]

The advance credit is not to exceed 70% of the average wages paid by the employer in 2019.[33]

Special rules apply to seasonal employers and those not in existence in 2019. For seasonal employers the special provision provides:

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[30] Repeal of CARES Act §2301(c)(3)(B)

[31] CARES Act §2301(h)(1) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §207(f)

[32] CARES Act §2301(j)(2)(A) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §207(g)(1)

[33] CARES Act §2301(j)(2)(A) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §207(g)(1)

> In the case of any employer who employs seasonal workers (as defined in section 45R(d)(5)(B) of the Internal Revenue Code of 1986), the employer may elect to substitute 'the wages for the calendar quarter in 2019 which corresponds to the calendar quarter to which the election relates' for 'the average quarterly wages paid by the employer in calendar year 2019'[34]

For employers not in existence in 2019, the above rules shall be applied by substituting 2020 for 2019 as the base period being evaluated for the advance payment amount.[35]

The ERC for the quarter shall be reduced (but not below zero) by the amount of the advance credit. A failure to reduce the credit by the advance payment shall be treated as a mathematical or clerical error under IRC §6213(b)(1).[36]

If an excess advance payment exists for a quarter, the FICA or Railroad Retirement Tax Act tax imposed on the employer shall be increased by the amount of the excess.[37]

Third-Party Payors

The Act provides the following provision related to third-party payors (such as certified professional employer organizations):

> Any forms, instructions, regulations, or guidance described in paragraph (2) shall require the customer to be responsible for the accounting of the credit and for any liability for improperly claimed credits and shall require the certified professional employer organization or other third party payor to accurately report such tax credits based on the information provided by the customer.[38]

Public Awareness Campaign

The law requires the IRS to conduct a public awareness campaign in coordination with the Small Business Administration to provide information regarding the availability of the ERC.[39] As part of that campaign the IRS shall

[34] CARES Act §2301(j)(2)(B) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §207(g)(1)
[35] CARES Act §2301(j)(2)(C) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §207(g)(1)
[36] CARES Act §2301(j)(3)(A) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §207(g)(1)
[37] CARES Act §2301(j)(3)(B) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §207(g)(1)
[38] CARES Act §2301(l) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §207(h)
[39] CARES Act §2301(n)(1) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §207(i)

- Provide to all employers, which reported not more than 500 employees on the most recently filed return of applicable employment taxes, a notice about the credit allowed under this section and the requirements for eligibility to claim the credit,[40] and

- Not later than 30 days after the date of the enactment of this subsection, provide to all employers educational materials relating to the credit allowed under this section, including specific materials for businesses with not more than 500 employees.[41]

Effective Date—Quarters Beginning in 2021

A key issue to remember about all changes described in this second ERC section is they only become effective for calendar quarters beginning in 2021.[42] Thus, unlike the first set of changes, none of these changes apply retroactively to quarters back to the enactment of the CARES Act.

Extension of Credits for Paid Sick and Family Leave

The *COVID-related Tax Relief Act of 2020* provides for an extension of the credit offered for employer paid sick and family leave, but does not extend the mandate to provide such leave beyond December 31, 2020.[43]

The credits are revised so they are now available:

- When such sick leave is required to be paid by reason of the Emergency Paid Sick Leave Act and

- Would be required if the mandate ended on March 31, 2021 when all other requirements for such leave are met.[44]

Time Period Over Which Deferred Employee FICA is to Be Withheld in 2021

Congress orders in the Act that the IRS shall modify Notice 2020-65 to provide that any amount of employee FICA deferred during the period September 1, 2020 to December 31, 2020 will be recovered from employees' paychecks over the entirety of 2021, not just the first four months of the year and penalties will only apply to amounts not transmitted to the IRS by January 1, 2022.[45]

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[40] CARES Act §2301(n)(2)(A) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §207(i)

[41] CARES Act §2301(n)(2)(B) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §207(i)

[42] Taxpayer Certainty and Disaster Relief Act of 2020 §207(k)

[43] COVID-related Tax Relief Act of 2020 §286

[44] COVID-related Tax Relief Act of 2020 §286(a)(1) and (3)

[45] COVID-related Tax Relief Act of 2020 §274

MISCELLANEOUS BUSINESS-RELATED TAX ISSUES

The Acts have various other business-related issues.

Restaurant-Provided Business Meals Fully Deductible in 2021 and 2022

The Act provides for a limited and temporary suspension of the 50% reduction in the deduction for most business food and beverages under IRC §274(n) during 2021 and 2022. The temporary allowance of the full deduction is:

- For food or beverages provided by a restaurant, and
- Paid or incurred before January 1, 2023.[46]

The provision applies to amounts paid or incurred after December 31, 2020.[47]

Election to Waive Application of Certain Modifications to Farm Losses

Taxpayers with farming losses from 2018 and later years prior to the CARES Act had the ability to carryback losses two years, but the CARES Act retroactively removed that option and made the carryback period for all businesses five years. While for most non-farm businesses this was a positive development—they could either go back five years or elect to carry forward the loss as they had been required to under the Tax Cuts and Jobs Act changes—for farms they could not maintain the two-year carryback even if that was the most advantageous option.

Congress has decided that farmers should be allowed to elect to keep the two year carryback, so a taxpayer may elect to ignore the changes made by the CARES Act to net operating losses, keeping the two year carryback period.[48] Such an election shall be made in the manner specified by the IRS and once made will be irrevocable.[49]

The general timing rules for making this election are defined as follows:

> An election under this paragraph shall be made by the due date (including extensions of time) for filing the taxpayer's return for the taxpayer's first taxable year ending after the date of the enactment of the COVID-related Tax Relief Act of 2020.[50]

46 IRC §274(n)(D) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §210(a)
47 Taxpayer Certainty and Disaster Relief Act of 2020 §210
48 IRC §170(e)(1) as amended by the COVID-related Tax Relief Act of 2020 §281(c)(1)
49 IRC §170(e)(2) as amended by the COVID-related Tax Relief Act of 2020 §281(c)(1)
50 IRC §170(e)(1)(B)(ii)(I) as amended by the COVID-related Tax Relief Act of 2020 §281(a)

For taxpayers that had already filed affected returns before the date of enactment of the *COVID-related Tax Relief Act of 2020* the following provisions apply:

> In the case of any taxable year for which the taxpayer has filed a return of Federal income tax before the date of the enactment of the COVID-related Tax Relief Act of 2020, which disregards the amendments made by subsections (a) and (b), such taxpayer shall be treated as having made an election under this paragraph unless the taxpayer amends such return to reflect such amendments by the due date (including extensions of time) for filing the taxpayer's return for the first taxable year ending after the date of the enactment of the COVID-related Tax Relief Act of 2020.[51]

An election to waive a carryback under IRC §172(b)(3) may be revoked for any election:

- Which was made before the date of the enactment of the COVID-related Tax Relief Act of 2020, and
- Which relates to the carryback period provided under section 172(b)(1)(B) of such Code with respect to any net operating loss arising in taxable years beginning in 2018 or 2019.[52]

Residential Property in an Electing Real Property Trade or Business Depreciated Over 30-Year Period

The *Taxpayer Certainty and Disaster Relief Act of 2020* provided some retroactive relief for an electing real property trade or business holding residential property.

Under the *Tax Cuts and Jobs Act* (TCJA), certain real property trades and businesses have the option to avoid the application of the business interest rules of IRC §163(j) by making an election. In such a case, all real property of the business is required to be depreciated using the alternative depreciation recovery (ADR) system. TCJA reduced the ADR life for residential real property to 30 years from 40, but it only applied to assets placed in service after September 27, 2017.

Thus, a business that made the electing real property trade or business election with residential buildings held before that date faced a much longer extra depreciation period than ones that acquired a building after September 27, 2017. The new law remedies this situation for residential real estate.

The new 30-year ADR life will be used for residential rental property that meets the following requirements:

[51] IRC §170(e)(1)(B)(ii)(II) as amended by the COVID-related Tax Relief Act of 2020 §281(a)

[52] IRC §170(e)(2) as amended by the COVID-related Tax Relief Act of 2020 §281(a)

- Which was placed in service before January 1, 2018,
- Which is held by an electing real property trade or business (as defined in section 163(j)(7)(B) of the Internal Revenue Code of 1986), and
- For which subparagraph (A), (B), (C), (D), or (E) of section 168(g)(1) (which would have already required the use of ADR depreciation) of the Internal Revenue Code of 1986 did not apply prior to such date.[53]

The revision retroactively applies to all taxable years beginning after December 31, 2017.[54]

Tax Treatment of PPP and Second Draw Debt Forgiveness

A major concern for many CPAs and their clients was the status of any deduction for expenses used to pay PPP loans. The IRS had indicated in Notice 2020-32 that expenditures that were used to obtain PPP forgiveness would not be deductible for income tax purposes and, in Revenue Ruling 2020-27., ruled that this would apply even if forgiveness had not been obtained by year-end so long as the taxpayer reasonably expected the expenditures to result in forgiveness.

Section 276 of the *Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act* revises the original §1106(i)[55] of the CARES Act, which provided that the forgiveness would not be taxable, clarifying that, as well, no deductions would be denied based on that forgiveness. Specifically:

- No amount shall be included in the gross income of the eligible recipient by reason of forgiveness of PPP loan indebtedness, and
- No deduction shall be denied, no tax attribute shall be reduced, and no basis increase shall be denied, by reason of the exclusion from gross income of that amount.[56]

The same rules will apply to PPP second draw loans.[57]

For partnerships and S corporations, any amount of cancellation of indebtedness income under the program will be treated as tax-exempt income for purposes of IRC §§705 and 1366, thus meaning the amount will increase the equity holder's basis in

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[53] TCJA §13204(b)(3) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §202

[54] Taxpayer Certainty and Disaster Relief Act of 2020 §202

[55] The entirety of §1106 of the CARES Act is also moved to §7A of the Small Business Act, so references to §7A are references to §1106 of the CARES Act.

[56] SBA §7A(i)(1) and (2) (previously CARES Act §1106) as amended by Covid-Related Tax Relief Act of 2020 §276(a)

[57] Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act §276(b)

his/her interest.[58] And, except as provided for by the IRS, any increase in the adjusted basis of a partner's interest in a partnership due to that tax-exempt income will be equal to the partner's distributive share of the forgiven expenses that lead to the debt cancellation.[59]

The IRS may provide an exception from having to file information returns otherwise required by a lender for amounts excluded from income by SBA §7A(i) (the PPP loan forgiveness) or §§276(b), 277 or 278 of the *COVID-related Tax Relief Act of 2020*.[60]

NON-PPP LOAN FORGIVENESS TAXATION

The law provides relief for the taxation of loan forgiveness and similar support under various federal COVID-19 programs.

Nontaxability of Forgiveness of Indebtedness Under United States Treasury Program Management Authority

For the United States Treasury Program Management Authority assistance:

- No amount shall be included in the gross income of a borrower by reason of forgiveness of indebtedness described in section 1109(d)(2)(D) of the CARES Act,
- No deduction shall be denied, no tax attribute shall be reduced, and no basis increase shall be denied, by reason of the exclusion from gross income provided under the prior bullet and
- In the case of a borrower that is a partnership or S corporation—
  - Any amount excluded from income by reason of the first bullet shall be treated as tax exempt income for purposes of sections 705 and 1366 of the Internal Revenue Code of 1986, and
  - Except as provided by the Secretary of the Treasury (or the Secretary's delegate), any increase in the adjusted basis of a partner's interest in a partnership under section 705 of the Internal Revenue Code of 1986 with respect to any amount described in the prior bullet shall equal the partner's distributive share of deductions resulting from costs giving rise to forgiveness described in section 1109(d)(2)(D) of the CARES Act.[61]

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[58] SBA §7A(i)(3)(A) (previously CARES Act §1106) as amended by Covid-Related Tax Relief Act of 2020 §276(a)
[59] SBA §7A(i)(3)(B) (previously CARES Act §1106) as amended by Covid-Related Tax Relief Act of 2020 §276(a)
[60] COVID-related Tax Relief Act of 2020 §279
[61] COVID-related Tax Relief Act of 2020 §278(a)

Tax Status of Emergency EIDL Grants and Targeted EIDL Advances

For purposes of the Internal Revenue Code:

- Any EIDL Emergency Grant or any funding under section 331 of the *Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act* shall not be included in the gross income of the person that receives such advance or funding,

- No deduction shall be denied, no tax attribute shall be reduced, and no basis increase shall be denied, by reason of the exclusion from gross income provided by the first bullet, and

- In the case of a partnership or S corporation that receives such advance or funding—

  - Any amount excluded from income by reason of the first bullet shall be treated as tax exempt income for purposes of sections 705 and 1366 of the Internal Revenue Code of 1986, and

  - The Secretary of the Treasury (or the Secretary's delegate) shall prescribe rules for determining a partner's distributive share of any amount described in the prior bullet for purposes of section 705 of the Internal Revenue Code of 1986.[62]

Tax Status of Loan Payments Made by SBA for Borrowers

For purposes of the Internal Revenue Code:

- Any payment of various SBA loans described in section 1112(c) of the CARES Act shall not be included in the gross income of the person on whose behalf such payment is made,

- No deduction shall be denied, no tax attribute shall be reduced, and no basis increase shall be denied, by reason of the exclusion from gross income provided by the first bullet, and

- In the case of a partnership or S corporation on whose behalf of a payment described in section 1112(c) of the CARES Act is made—

  - Any amount excluded from income by reason of the first bullet shall be treated as tax exempt income for purposes of sections 705 and 1366 of the Internal Revenue Code of 1986, and

[62] COVID-related Tax Relief Act of 2020 §278(b)

- Except as provided by the Secretary of the Treasury (or the Secretary's delegate), any increase in the adjusted basis of a partner's interest in a partnership under section 705 of the Internal Revenue Code of 1986 with respect to any amount described in the prior bullet shall equal the sum of the partner's distributive share of deductions resulting from interest and fees described in section 1112(c) of the CARES Act and the partner's share, as determined under section 752 of the Internal Revenue Code of 1986, of principal described in section 1112(c) of the CARES Act.[63]

SBA guidance issued to lenders prior to the enactment of the *Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act* had indicated that these payments would be reported to borrowers on Form 1099-MISC and be taxable to the borrower.[64] As was noted in the section on PPP loans, those information returns no longer have to be filed and, as was described above, these payments will not give rise to taxable income.

Tax Status of Grants for Shuttered Venue Operators

For purposes of the Internal Revenue Code:

- Any grant made under section 324 of the Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act (Grants for Shuttered Venue Operators) shall not be included in the gross income of the person that receives such grant,

- No deduction shall be denied, no tax attribute shall be reduced, and no basis increase shall be denied, by reason of the exclusion from gross income provided by the first bullet, and

- In the case of a partnership or S corporation that receives such grant—

  - Any amount excluded from income by reason of the first bullet shall be treated as tax exempt income for purposes of sections 705 and 1366 of the Internal Revenue Code of 1986, and

  - The Secretary of the Treasury (or the Secretary's delegate) shall prescribe rules for determining a partner's distributive share of any amount described in the prior bullet for purposes of section 705 of the Internal Revenue Code of 1986.[65]

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[63] COVID-related Tax Relief Act of 2020 §278(c)

[64] See Ed Zollars, CPA, "Guidance on Information Reporting Responsibilities for Payments Under CARES Act §1112 Made by SBA," *Current Federal Tax Developments* website, December 12, 2020, https://www.currentfederaltaxdevelopments.com/blog/2020/12/12/guidance-on-information-reporting-responsibilities-for-payments-under-cares-act-1112-made-by-sba (retrieved December 17, 2020)

[65] COVID-related Tax Relief Act of 2020 §278(d)

EMPLOYEE BENEFIT PLAN RELATED RELIEF

As Congress did in the CARES Act, Congress continues to make some revisions to qualified plan rules in these bills.

Minimum Age for Distributions During Working Retirement for Some Workers in the Construction Industry

A narrow expansion was created for certain workers in long-standing multiemployer retirement plans. Generally, IRC §401(a)(36) provides a qualified plan may allow workers who have attained age 59 ½ to take distributions while continuing to work. The new provision allows that age to be reduced to age 55 if:

- The individual was a participant in the plan on or before April 30, 2013;
- The plan was in existence prior to January 1, 1970; and
- Before December 31, 2011, at a time when the plan provided that distributions may be made to an employee who has attained age 55 and who is not separated from employment at the time of such distribution, the plan received at least 1 written determination from the Internal Revenue Service that the plan constituted a qualified retirement plan.[66]

The provision applies to distributions made before, on, or after the date of enactment.[67]

Temporary Rule Preventing Partial Plan Termination

A COVID-19 related rule has been added to prevent plans from being treated as having a partial plan termination in 2020 within the meaning of IRC §411(d)(3). Generally, if an employer lays off more than 20% of its employees in a year, that constitutes a partial termination of the plan and, under IRC §411(d)(3), requires all such affected employees' balances in their retirement accounts to be treated as fully vested.

§209 of the *Taxpayer Certainty and Disaster Relief Act of 2020* provides that a plan "shall not be treated as having a partial termination (within the meaning of 411(d)(3) of the Internal Revenue Code of 1986) during any plan year which includes the period beginning on March 13, 2020, and ending on March 31, 2021, if the number of active participants covered by the plan on March 31, 2021 is at least 80 percent of the number of active participants covered by the plan on March 13, 2020."[68]

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[66] IRC §401(a)(36) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §208(a)

[67] Taxpayer Certainty and Disaster Relief Act of 2020 §208(b)

[68] Taxpayer Certainty and Disaster Relief Act of 2020 §209

Temporary Modification of Rules for Health and Dependent Care Flexible Spending Arrangements

The COVID-19 pandemic became a serious issue in the United States in March of 2020, well after employees had made their deferral elections related to health and dependent care flexible spending arrangements in their employer's cafeteria plans under IRC §125. In many cases, taxpayers may have ended 2020 with a substantial amount of unused funds in such accounts.

Plan May Adopt Unlimited Carryover of Amounts from 2020 to 2021

Congress has enacted a special provision allowing plans, *if the plan decides to do so*, to allow participants to carry unused 2020 balances in such flexible spending arrangements in full into the following plan year. The provision reads:

> (a) CARRYOVER FROM 2020 PLAN YEAR.—For plan years ending in 2020, a plan that includes a health flexible spending arrangement or dependent care flexible spending arrangement shall not fail to be treated as a cafeteria plan under the Internal Revenue Code of 1986 merely because such plan or arrangement permits participants to carry over (under rules similar to the rules applicable to health flexible spending arrangements) any unused benefits or contributions remaining in any such flexible spending arrangement from such plan year to the plan year ending in 2021.
>
> (b) CARRYOVER FROM 2021 PLAN YEAR.—For plan years ending in 2021, a plan that includes a health flexible spending arrangement or dependent care flexible spending arrangement shall not fail to be treated as a cafeteria plan under the Internal Revenue Code of 1986 merely because such plan or arrangement permits participants to carry over (under rules similar to the rules applicable to health flexible spending arrangements) any unused benefits or contributions remaining in any such flexible spending arrangement from such plan year to the plan year ending in 2022.[69]

Option to Provide an Extension of Grace Periods for Cafeteria Plans

Similar to the unlimited carryover rule, the law also provides for cafeteria plans with a grace period to extend that grace period for a plan year ending in 2020 or 2021 to 12 months after the end of the plan year. Again, a plan is not required to do this, but rather a plan is allowed to make this revision.

[69] Taxpayer Certainty and Disaster Relief Act of 2020 §214(a) and (b)

The provision reads:

> A plan that includes a health flexible spending arrangement or dependent care flexible spending arrangement shall not fail to be treated as a cafeteria plan under the Internal Revenue Code of 1986 merely because such plan or arrangement extends the grace period for a plan year ending in 2020 or 2021 to 12 months after the end of such plan year, with respect to unused benefits or contributions remaining in a health flexible spending arrangement or a dependent care flexible spending arrangement.[70]

Option to Allow for Post-Termination Reimbursements from Health FSAs

The Act allows plans to adopt provisions to allow for post-termination reimbursements from health FSAs for participants that cease participation in 2020 or 2021. The rule reads:

> A plan that includes a health flexible spending arrangement shall not fail to be treated as a cafeteria plan under the Internal Revenue Code of 1986 merely because such plan or arrangement allows (under rules similar to the rules applicable to dependent care flexible spending arrangements) an employee who ceases participation in the plan during calendar year 2020 or 2021 to continue to receive reimbursements from unused benefits or contributions through the end of the plan year in which such participation ceased (including any grace period, taking into account any modification of a grace period permitted under paragraph (1)).[71]

Special Carry Forward Rule for Dependent Care Flexible Spending Arrangements Where the Dependent Aged Out During Pandemic

Another situation that may have impacted some participants in dependent care FSAs was that their child “aged out” of eligibility for dependent care coverage while funds set in the account unspent. For those participants, merely allowing the funds to be carried over would not serve to solve their problem—the child is now too old for the expenditure from the FSA to be treated as an eligible dependent care benefit.

For purposes of benefits carried over for eligible employees only, the maximum age for dependent care benefits will be temporarily increased from age 13 to age 14.[72]

An *eligible employee* means any employee who:

[70] Taxpayer Certainty and Disaster Relief Act of 2020 §214(c)(1)
[71] Taxpayer Certainty and Disaster Relief Act of 2020 §214(c)(2)
[72] Taxpayer Certainty and Disaster Relief Act of 2020 §214(d)(1) and (2)

- is enrolled in a dependent care flexible spending arrangement for the last plan year with respect to which the end of the regular enrollment period for such plan year was on or before January 31, 2020, and
- has one or more dependents (as defined in section 152(a)(1) of the Internal Revenue Code of 1986) who attain the age of 13—
  - during such plan year, or
  - in the case of an employee who (after the application of this section) has an unused balance in the employee's account under such arrangement for such plan year (determined as of the close of the last day on which, under the terms of the plan, claims for reimbursement may be made with respect to such plan year), the subsequent plan year.[73]

Change in Election Amount

As well, a plan can add a provision allowing for prospective changes in contributions to an FSA without regard to a change in status for plan years ending in 2021:

> For plan years ending in 2021, a plan that includes a health flexible spending arrangement or dependent care flexible spending arrangement shall not fail to be treated as a cafeteria plan under the Internal Revenue Code of 1986 merely because such plan or arrangement allows an employee to make an election to modify prospectively the amount (but not in excess of any applicable dollar limitation) of such employee's contributions to any such flexible spending arrangement (without regard to any change in status).[74]

Timing of Plan Amendments

As was noted, all of these provisions merely allow a plan to offer such benefits. If the employer does wish to offer such benefits, the cafeteria plan will need to be amended eventually, although not before the employer begins offering these benefits. The law provides for the following delayed amendment option:

> A plan that includes a health flexible spending arrangement or dependent care flexible spending arrangement shall not fail to be treated as a cafeteria plan under the Internal Revenue Code of 1986 merely because such plan or arrangement is amended pursuant to a provision under this section and such amendment is retroactive, if—

[73] Taxpayer Certainty and Disaster Relief Act of 2020 §214(d)(3)
[74] Taxpayer Certainty and Disaster Relief Act of 2020 §214(e)

> (1) such amendment is adopted not later than the last day of the first calendar year beginning after the end of the plan year in which the amendment is effective, and
>
> (2) the plan or arrangement is operated consistent with the terms of such amendment during the period beginning on the effective date of the amendment and ending on the date the amendment is adopted.[75]

ENERGY-RELATED RELIEF

A number of energy-related provisions made their way into the various bills that were part of the *Consolidated Appropriations Act, 2021*.

Waste Energy Recovery Property Eligible for Energy Credit

Waste energy recovery property is added to the list of energy properties eligible for the 30% IRC §48 energy credit.[76] The property is subject to the phase-out found at IRC §48(a)(7).[77]

Waste energy recovery property is defined as:

> …property that generates electricity solely from heat from buildings or equipment if the primary purpose of such building or equipment is not the generation of electricity.[78]

Such property also must meet a capacity limitation:

> The term 'waste energy recovery property' shall not include any property which has a capacity in excess of 50 megawatts.[79]

The following "no double benefit" rule applies to such property:

> Any waste energy recovery property (determined without regard to this subparagraph) which is part of a system which is a combined heat and power system property shall not be treated as waste energy recovery property for purposes of this section unless the taxpayer elects to not treat such system as a combined heat and power system property for purposes of this section.[80]

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[75] Taxpayer Certainty and Disaster Relief Act of 2020 §214(g)

[76] IRC §48(a)(3)(A)(viii) and §48(a)(2)(A)(i)(V) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §203(a)

[77] IRC §48(a)(7) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §203(c)

[78] IRC §48(c)(5)(A) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §203(d)

[79] IRC §48(c)(5)(B) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §203(d)

[80] IRC §48(c)(5)(C) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §203(d)

In order to qualify as waste energy recovery property construction must begin before January 1, 2024.[81]

These changes apply to periods after December 31, 2020, "under rules similar to the rules of section 48(m) as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990."[82]

Extension of Energy Credit for Offshore Wind Facilities

The energy credit for offshore wind facilities is separately extended so that a credit for this type of facility is available for construction which begins before January 1, 2026, the phase-out reduction of the percentage credit for wind facilities will not apply to offshore wind facilities, and for purposes of the qualified facility definition of IRC §45(d)(1), the date that construction must begin by is pushed back to January 1, 2026.[83]

A qualified offshore wind facility is defined as:

> …a qualified facility (within the meaning of section 45) described in paragraph (1) of section 45(d) (determined without regard to any date by which the construction of the facility is required to begin) which is located in the inland navigable waters of the United States or in the coastal waters of the United States.[84]

These changes apply to periods after December 31, 2016, "under rules similar to the rules of section 48(m) as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990."[85]

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81 IRC §48(c)(5)(D) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §203(d)

82 Taxpayer Certainty and Disaster Relief Act of 2020 §203(e)

83 IRC §48(a)(5)(F) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §204(a)

84 IRC §48(a)(5)(F)(ii) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §204(a)

85 Taxpayer Certainty and Disaster Relief Act of 2020 §204(b)

NOTES

Unit 3

Consolidated Appropriations Act: Extenders

LEARNING OBJECTIVES

When you have completed this unit, you will be able to

- **List** the tax provisions that had been scheduled to expire in 2020 that have been extended for various periods of time by Congress
- **Assist** clients in making use of these provisions in years after 2020

Congress addressed a number of expiring tax provisions in the *Taxpayer Certainty and Disaster Relief Act of 2020*.

ITEMS MADE PERMANENT

Congress took some items off the extender list and made them permanently part of the law as part of this law. Of course "permanent" merely means they have no explicit expiration date, not that Congress might not change them later. But, for now, these issues no longer are something advisers will have to wonder every so often if they will be renewed at a fixed date in the future.

Medical Expense Deduction Floor

Congress has now made permanent the 7.5% floor on the deduction of medical expenses on Schedule A.[86] The floor had been scheduled to increase to 10% for all taxpayers, a level that previously had applied to taxpayers under age 65.

[86] IRC §213(a) and (f) as amended by the Taxpayer Certainty and Disaster Relief Act of 2020 §101.

Energy-Efficient Commercial Building Deduction under IRC §179D

Congress both made permanent[87] and revised the energy-efficient commercial building deduction under IRC §179D.

For tax years beginning after 2020, the maximum amount of the deduction under IRC §179D(b) and the computation of a partial allowance under IRC §179D(d)(1)(A) will be increased by an amount calculated by multiplying the amounts by the general cost of living adjustments found at IRC §1(f)(3) for the calendar year in which the taxable year begins, using calendar year 2019 as the base year.[88]

As well, various technical standards used in the section are updated.[89]

The amendments apply to property placed in service after December 31, 2020.[90]

Benefits to Volunteer Firefighters and Emergency Medical Responders Excluded from Gross Income

A provision that had been missing from the law for many years before being brought back into the law last year for a single year has now been made a permanent part of the law.[91] IRC §139B, which treats certain *qualified State and local tax benefits* and *qualified payments* made to volunteer firefighters and emergency medical responders as not part of gross income, was scheduled to expire at the end of 2020.

A *qualified state and local tax benefit* is any reduction or rebate of the following taxes:

- State and local real property taxes.
- State and local personal property taxes.
- State and local income, war profits, and excess profits taxes

provided by a State or political division thereof on account of services performed as a member of a qualified volunteer emergency response organization.[92]

A *qualified payment* is any payment provided by a State or political division thereof on account of the performance of services as a member of a qualified volunteer emergency

[87] Deletion of existing IRC §179D(h) by the Taxpayer Certainty and Disaster Relief Act of 2020 §102
[88] IRC §179D(g) after amendment by the Taxpayer Certainty and Disaster Relief Act of 2020 §102
[89] IRC §179D(d)(2) and (e) after amendment by the Taxpayer Certainty and Disaster Relief Act of 2020 §102
[90] Taxpayer Certainty and Disaster Relief Act of 2020 §102(d)
[91] IRC §139D(d) removed by Taxpayer Certainty and Disaster Relief Act of 2020 §103(a)
[92] IRC §139D(c)(1)

response organization. The amount of the excludable payment is capped at $50 times the number of months the taxpayer performs these services.[93]

A qualified volunteer emergency response organization is any volunteer organization:

- which is organized and operated to provide firefighting or emergency medical services for persons in the State or political subdivision, as the case may be, and

- which is required (by written agreement) by the State or political subdivision to furnish firefighting or emergency medical services in such State or political subdivision.[94]

Transition from a Deduction for Qualified Tuition and Related Expenses to an Increased Income Limitation on the Lifetime Learning Credit

In the case of the deduction for qualified tuition, Congress did not decide to make the deduction permanent, despite putting this provision in a Subtitle of the bill entitled "Certain Provisions Made Permanent." Rather, Congress decided to replace the deduction by expanding the income level at which taxpayers will qualify to claim the Lifetime Learning Credit.[95]

What Congress ends up doing is aligning the phase-outs for the American Opportunity Tax Credit and the Lifetime Learning Credit. Now the Lifetime Learning Credit will phase out between modified adjusted gross income of:

- $80,000 to $90,000 for individuals other than those filing a joint return and

- $160,000 to $180,000 for taxpayers filing a joint return.[96]

The Act removes the inflation adjustment to IRC §25A numbers previously found at IRC §25A(h).[97]

The qualified tuition and fees deduction found at IRC §222 is removed from the law.[98]

The changes are effective for tax years beginning after December 31, 2020.[99]

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93 IRC §139D(c)(2)
94 IRC §139D(c)(3)
95 Taxpayer Certainty and Disaster Relief Act of 2020 §104
96 IRC §25D(1) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §104(a)(1)
97 Taxpayer Certainty and Disaster Relief Act of 2020 §104(a)(2)
98 Taxpayer Certainty and Disaster Relief Act of 2020 §104(b)
99 Taxpayer Certainty and Disaster Relief Act of 2020 §104(c)

Railroad Track Maintenance Credit

The railroad tax maintenance credit found at IRC §45G is made permanent by the Act.[100]

The credit rate is being reduced beginning with taxable years beginning after December 31, 2022 to 40% from 50%.[101]

PROVISIONS EXTENDED THROUGH 2025

A number of provisions were extended through 2025, the date that most of the individual provisions in the Tax Cuts and Jobs Act are scheduled to expire. That means these items will not be revisited for a number of years, but adds to the issue that will be faced at the end of 2025 as a large number of provisions leave the law.

Look-Through Rule for Related Controlled Foreign Corporations

The look-through rule for related controlled foreign corporations under IRC §954(c)(6) is extended through years ending December 31, 2025.[102]

New Markets Tax Credit

The new markets tax credit under IRC §45 is extended at the limitation of $5,000,000,000 for each of calendar years 2021-2025.[103]

The carryover period found in IRC §45(f)(3) is extended to 2030.[104]

Work Opportunity Credit

The work opportunity credit found at IRC §51 is extended for amounts paid or incurred to an eligible individual who begins work for the employer on or before December 31, 2025.[105]

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[100] Taxpayer Certainty and Disaster Relief Act of 2020 §105(a) striking IRC §45G(h)
[101] IRC §45G(b) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §105(b)
[102] IRC §954(c)(6)(C) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §111(a)
[103] IRC §45D(f)(1)(H) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §112(a)
[104] IRC §45D(f)(3) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §112(b)
[105] IRC §51(c)(4) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §113(a)

Exclusion from Gross Income of Discharge of Qualified Principal Residence Indebtedness

The exclusion under IRC §108(a)(1)(E) for discharge of qualified principal residence indebtedness now applies to debts discharged:

- Before January 1, 2026, or
- Subject to an arrangement that is entered into and evidenced in writing before January 1, 2026.[106]

However, this extension comes with a major reduction in the amount of such debt that is taken into account for this exclusion, limiting it to $750,000 ($375,000 for a married couple filing a separate return).[107] This reduced exclusion will apply to discharges of indebtedness after December 31, 2020.[108]

7-Year Recovery Period for Motorsports Entertainment Complexes

The 7-year recovery period for motorsports entertainment complexes will remain available for property placed in service through December 31, 2025.[109]

Expensing Rules for Certain Productions

The election under §181 to treat the cost of any qualified film or television production, and any qualified live theatrical production as an expense has been extended for any such production commencing on or before December 31, 2025.[110]

Empowerment Zone Tax Incentives

The date through which the designation of an empowerment zone shall remain effective per IRC §1391 has been extended through December 31, 2025.[111]

However, the increase in §179 expensing for an enterprise zone business shall end on December 31, 2020.[112] Similarly, the nonrecognition of gain on rollover of empowerment zone investments under §1397B will terminate for sales in taxable years beginning after December 31, 2020.[113]

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106 IRC §108(e)(1)(E) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §114(a)
107 IRC §108(h)(2) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §114(b)
108 Taxpayer Certainty and Disaster Relief Act of 2020 §114(c)
109 IRC §168(i)(15)(D) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §115(a)
110 IRC §181(g) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §116(a)
111 IRC §1391(d)(1)(A)(i) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §118(a)
112 IRC §1397A(c) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §118(b)
113 IRC §1397B(c) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §118(c).

In the case of a designation of an empowerment zone the nomination for which included a termination date which is contemporaneous with December 31, 2020 (formerly the required latest termination of empowerment zone status prior to these amendments), that termination date will no long apply if, after the date of the enactment of the *Taxpayer Certainty and Disaster Relief Act of 2020*, the entity which made such nomination amends the nomination to provide for a new termination date in such manner as the IRS may provide.[114]

Employer Credit for Paid Family Leave

The employer credit for paid leave under the Family Medical Leave Act found at IRC §45S of between 12.5% and 25% of qualified wages paid to an employee during such leave has been extended for wages paid for taxable years beginning on or before December 31, 2025.[115]

Exclusion for Certain Employer Payments of Student Loans

The CARES Act had added payment of principal and interest on qualified student loans as an eligible reimbursement under an employer's §127 plan for 2020. The *Taxpayer Certainty and Disaster Relief Act of 2020* continues that category of allowed reimbursable expense under such plans for payments made before January 1, 2026.[116]

Extension of Carbon Oxide Sequestration Credit

The carbon oxide sequestration credit under IRC §45Q has been extended to allow construction of a facility to begin before January 1, 2026, rather than January 1, 2024 as had been the law prior to this change.[117]

EXTENSIONS OF OTHER PROVISIONS

Other provisions are extended for various periods of time, not linked to the expiration of many Tax Cuts and Jobs Act Provisions.

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114 Taxpayer Certainty and Disaster Relief Act of 2020 §118(d)
115 IRC §45S(i) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §119(a)
116 IRC §127(c) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §120(a)
117 IRC §45Q(d)(1) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §121(a)

Credit for Electricity Produced from Certain Renewable Resources

The credit under IRC §45(d) for various items is extended to cover construction that begins before January 1, 2022, one year beyond the prior expiration date. The categories covered are:

- Wind facilities;
- Closed-loop biomass facilities;
- Open-loop biomass facilities;
- Geothermal or solar energy facilities;
- Landfill gas facilities;
- Trash facilities;
- Qualified hydropower facility; and
- Marine and hydrokinetic renewable energy facilities.[118]

The election to treat qualified facilities as energy property under §48(a)(5)(C)(ii) is extended to cover property where construction begins before January 1, 2022.[119]

The phase-out percentages provisions found at IRC §§45(b)(5)(D) and 48(a)(5)(E)(iv) are amended to conform to the new dates above.[120]

Extension and Phase-Out of Energy Credit

A number of extensions and revisions are made to the energy credit at IRC §48.

The date by which construction must begin on

- Equipment that uses solar energy to illuminate the inside of a structure using fiber-optic distributed sunlight;[121]

[118] IRC §45(d)(1), (2)(A), 3(A), 4(B), (6), (7), (9) and (11)(B) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §131(a)

[119] IRC §48(a)(5)(C)(ii) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §131(b)

[120] IRC §§45(b)(5)(D) and 48(a)(5)(E)(iv) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §131(c)

[121] IRC §§48(a)(2)(A)(i)(II) and (3)(A)(ii) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §132(a)

- Equipment that uses the ground or ground water as a thermal energy source to heat a structure or as a thermal energy sink to cool a structure;[122]
- Qualified fuel cell property;[123]
- Qualified microturbine property;[124]
- Combined heat and power system property;[125] and
- Qualified small wind energy property.[126]

has been pushed back to beginning before January 1, 2024, two years later than under previous law.

The various related phase-outs in §48 to the above items are also updated to reflect the new end date for the credits.[127]

Treatment of Mortgage Insurance Premiums as Qualified Residence Interest

The treatment of mortgage insurance premiums for contracts issued after January 1, 2007 as qualified residence interest is extended for amounts paid or accrued through December 31, 2021.[128]

Credit for Health Insurance of Qualified Individuals

The credit for health insurance of qualified individuals under IRC §35 is extended for one additional year, for months beginning before January 1, 2022.[129]

Indian Employment Credit

The Indian employment credit under §45A(f) is extended for one year, now applying to tax years beginning before or on December 31, 2020.[130]

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[122] IRC §48(a)(3)(A)(vii) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §132(a)
[123] IRC §48(c)(1)(D) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §132(a)
[124] IRC §48(c)(2)(D) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §132(a)
[125] IRC §48(c)(3)(A)(iv) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §132(a)
[126] IRC §48(c)(4)(C) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §132(a)
[127] IRC §48(a)(6)(A), (A)(i), A(ii), (B) and §48(a)(7)(A)(i) and (ii)as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §113(b)
[128] IRC §163(h)(3)(iv)(I) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §133(a)
[129] IRC §35(b)(1)(B) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §134(a)
[130] IRC §45A(b) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §135(a)

Mine Rescue Team Training Credit

The mine rescue team training credit under IRC §45N is extended for one year, now applying to tax years beginning before or on December 31, 2020.[131]

Classification of Certain Race Horses as 3-Year Property

The classification of certain race horses as 3-year MACRS property is extended to apply to horses:

- Placed in service by January 1, 2022 and
- Placed in service after December 31, 2021 and which is more than 2 years old at the time such horse is placed in service by such purchaser.[132]

Accelerated Depreciation for Business Property on Indian Reservations

The special lives for accelerated depreciation for property placed in service on an Indian reservation will apply to property placed in service through December 31, 2021.[133]

American Samoa Economic Development Credit

The American Samoa economic development credit is extended for one additional year.[134]

Nonbusiness Energy Property Credit

The nonbusiness energy property credit under IRC §25C is extended for one year, applying to property placed in service through December 31, 2021.[135]

Qualified Fuel Motor Vehicles Credit

The alternative motor vehicle credit on a new qualified fuel cell motor vehicle is extended by one year, applying to such a vehicle purchased by December 31, 2021.[136]

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[131] IRC §45N(e) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §136(a)

[132] IRC §168(e)(3)(A)(i) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §137(a)

[133] IRC §168(j)(9) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §138(a)

[134] Section 119(d) of division A of the Tax Relief and Health Care Act of 2006 as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §139(a)

[135] IRC §25C(g)(2) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §141(a)

[136] IRC §30B(k)(1) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §142(a)

Alternative Fuel Refueling Property Credit

The alternative fuel refueling property credit under IRC §30C is extended for one year, for property placed in service by December 31, 2021.[137]

2-Wheeled Plug-In Electric Vehicle Credit

The 2-wheeled plug-in electric vehicle credit under IRC §30D is extended for one year, for property acquired by December 31, 2021.[138]

Production Credit for Indian Coal Facilities

The production credit for Indian coal facilities under IRC §45 is revised to extend the production period to the 16-year period beginning on January 1, 2006.[139]

Energy Efficient Homes Credit

The energy efficient homes credit under IRC §45L is extended for one year, applying to qualified energy efficient homes acquired by December 31, 2021.[140]

Extension of Residential Energy-Efficient Property Credit and Inclusion of Biomass Fuel Property Expenditures

The residential energy efficient property credit under IRC §25D is extended for two years, for property placed in service by December 31, 2023.[141]

The applicable percentage at IRC §25D(g) is now set at:

- In the case of property placed in service after December 31, 2016, and before January 1, 2020, 30 percent,
- In the case of property placed in service after December 31, 2019, and before January 1, 2023, 26 percent, and
- In the case of property placed in service after December 31, 2022, and before January 1, 2024, 22 percent.[142]

The Act also adds a new category of property qualifying for the credit, *qualified biomass fuel property expenditures*.[143]

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137 IRC §30C(g) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §143(a)
138 IRC §30D(g) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §144(a)
139 IRC §45(e)(10)(A) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §145(a)
140 IRC §45L(g) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §146(a)
141 IRC §25D(h) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §148(a)(1)
142 IRC §25D(g) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §148(a)(2)
143 IRC §25D(a)(6) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §148(b)(1)

Qualified biomass fuel property expenditures are expenditures for property:

- Which uses the burning of biomass fuel to heat a dwelling unit located in the United States and used as a residence by the taxpayer, or to heat water for use in such a dwelling unit, and

- Which has a thermal efficiency rating of at least 75 percent (measured by the higher heating value of the fuel).[144]

Biomass fuel is defined as "any plant-derived fuel available on a renewable or recurring basis."[145]

To deny taxpayers a double-benefit via a non-business property credit under IRC §25C, the law removes from the list of energy-efficient building property a stove which uses the burning of biomass fuel to heat a dwelling unit located in the United States and used as a residence by the taxpayer, or to heat water for use in such a dwelling unit, and which has a thermal efficiency rating of at least 75 percent.[146]

The provisions related to an expenditure for qualified biomass fuel property expenditures takes effect for tax years beginning after December 31, 2020.[147]

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[144] IRC §25D(d)(6)(A) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §148(b)(2)
[145] IRC §25D(d)(6)(B) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §148(b)(2)
[146] IRC §25D(d)(3) as amended by Taxpayer Certainty and Disaster Relief Act of 2020 §148(b)(3)
[147] Taxpayer Certainty and Disaster Relief Act of 2020 §148(c)(2)

NOTES

Unit

4

American Rescue Plan Act of 2021

LEARNING OBJECTIVES

When you have completed this unit, you will be able to

- **Compute** the taxable portion of unemployment compensation for taxpayers on their 2020 income tax returns and under potential after year end planning opportunities.

- **Explain** to clients the differences between this recovery rebate program and the two that came before this one under the expanded child tax credit and the advance payment system that is set to start later in 2021

- **Apply** the extended and modified versions of the employee retention tax credit

On March 11, 2021, President Biden signed into law the American Rescue Plan Act (ARPA) of 2021. The Act, with a $1.9 trillion price tag, contained a number of provisions enacted under the reconciliation rules that are meant to provide certain types of additional relief related to the COVID-19 epidemic. This is the third major bill passed by Congress in just about one year dealing with the pandemic.

Most, but not all, of the tax provisions in this bill are short lived, with many impacting only a single year (2021

EXTEND THE EXCESS BUSINESS LOSS RULE BY ONE YEAR (ACT §9041)

March 11, 2021The Tax Cuts and Jobs Act added IRC §461(l) that limits an individual to deducting no more than an inflation adjusted $250,000 ($500,000 for a married couple filing a joint return) in net business losses in a year, with amounts in excess of that limit carried to the following year as a net operating loss. Originally, the provision was scheduled to expire for years beginning on or after January 1, 2026.

ARPA extends this rule for one additional year. So, it ceases to apply for years beginning on or after January 1, 2027.[148]

2021 RECOVERY REBATES TO INDIVIDUALS (ACT §9601)

Another round of recovery rebates are being sent out, though this time under somewhat different rules than the 2020 rebates. This tax credit is a refundable credit[149] for the first tax year beginning in 2021.[150]

Base Rebate Amount

The base rebate amount this time is set at:

- $1,400 ($2,800 for a joint return) plus
- $1,400 times the number of dependents claimed by the taxpayer.[151]

This time the dependent rebate is the same amount as that for a taxpayer and it is not limited only to dependents that are qualifying children.

Excluded Individuals

Again, rebates will not be available to:

- Any nonresident alien individual;
- Any individual who is a dependent of another taxpayer for a taxable year beginning in the calendar year in which the individual's taxable year begins; and
- An estate or trust.[152]

Phase-Out of Payments

A major change in this version of the recovery rebate is how quickly the rebate phases out. Previously, it phased out an amount equal to 5% of a taxpayer's adjusted gross income over the limit for that type of taxpayer. This time, while the beginning of the level of phase-out has not changed, the formula for phasing it out has been modified so that it phases out very quickly.

The rebate is phased out beginning at $75,000 for a single taxpayer or a married individual filing a separate return. It phases out entirely ratably over the next $5,000 of

[148] IRC §461(l)(1) as amended by the American Rescue Plan Act of 2021 §9041
[149] IRC §6428B(e)(3)
[150] IRC §6428B(a)
[151] IRC §6428B(b)(1)
[152] IRC §6428B(c)

adjusted gross income, with the rebate reduced to zero when the taxpayer's adjusted gross income exceeds $80,000. This is true regardless of how many dependents the taxpayer may claim.[153]

For a married couple, the phase-out of the rebate begins yet again at $150,000 (twice the amount of other filing statuses) but again sees a much more rapid phase-out, ratably being reduced for the next $10,000 of adjusted gross income and phasing out entirely at $160,000. Again, the number of dependents does not impact how quickly the taxpayers find the rebate eliminated entirely.[154]

For a taxpayer filing head of household status, the phase-out begins at $112,500 and entirely phases out (regardless of the number of dependents) over the next $7,500.[155]

Identification Number Rules

Similar rules as were found in the December 2027 Act apply for this recovery rebate with regard to identification numbers.

If a taxpayer does not provide a valid identification number on the return, the recovery rebate for that taxpayer is zero.[156] In the case of a joint return, the $2,800 is treated as $1,400 if only one spouse provides a valid identification number and zero if neither spouse provides such a number.[157] Similarly, a dependent must also provide a valid identification number to qualify for the $1,400 credit,[158] although an adoption taxpayer identification number can qualify as such a number for a dependent.[159]

For a married couple filing a joint return, if one spouse is a member of the armed forces and at least one spouse provides a valid identification number, the reduction of the base rebate does not apply.[160]

Advance Refund Coordination

The credit on the 2021 individual return will be reduced, but not below zero, by the advance refund amount paid to the taxpayer—that is, the payments made early in 2021 based on prior year information.[161]

[153] IRC §6428B(d)(1)
[154] IRC §6428B(d)(2)(A)
[155] IRC §6428B(d)(2)(B)
[156] IRC §6428B(e)(2)(A)
[157] IRC §6428B(e)(2)(B)
[158] IRC §6428B(e)(2)(C)
[159] IRC §6428B(e)(2)(D)(ii)
[160] IRC §6428B(e)(2)(E)
[161] IRC §6428B(f)

Advance Refunds and Credits

Each individual who was an eligible individual for that individual's first taxable year beginning in 2019 shall again be treated as having made a payment for that year equal to the advance refund—the amount that would have been allowed as a credit under this provision if the 2021 recovery rebate rules had applied to that year.[162]

All advance payments must be paid on or before December 31, 2021.[163]

Deceased Taxpayers and the Advance Refund

Special rules apply to deceased individuals. Generally, so long as the person was alive on January 1, 2021, he/she will qualify for an advance refund.[164]

Specifically, the law provides that, for purposes of determining the advance refund:

- Any individual who was deceased before January 1, 2021, shall be treated for purposes of applying subsection (e)(2) in the same manner as if the valid identification number of such person was not included on the return of tax for such taxable year (ignoring the special armed services rule);

- Notwithstanding the above, in the case of a joint return with respect to which only 1 spouse is deceased before January 1, 2021, such deceased spouse was a member of the Armed Forces of the United States at any time during the taxable year, and the valid identification number of such deceased spouse is included on the return of tax for the taxable year, the valid identification number of 1 (and only 1) spouse shall be treated as included on the return of tax for the taxable year; and

- No amount shall be allowed with respect to any dependent of the taxpayer if the taxpayer (both spouses in the case of a joint return) was deceased before January 1, 2021.[165]

Special Rules for 2020 Income Tax Returns

Although the advance is initially based on 2019 income tax returns, the law provides two special rules with regard to 2020 returns.

- If, at the time the IRS calculates the advance payment, the taxpayer has already filed a 2020 income tax return for his/her first tax year beginning in 2020, that return, rather than the 2019 return, will be used to compute the advance payment.

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[162] IRC §6428B(g)(1),(2)(A)
[163] IRC §6428B(g)(3)
[164] IRC §6428B(g)(2)(B)
[165] IRC §6428B(g)(2)(B)

- If that 2020 return is filed before the *additional payment determination date*, the IRS will determine if the individual would have qualified for a larger advance payment based on the 2020 return. If so, the taxpayer will receive a payment for the difference.[166]

However, "already filed" doesn't mean what you probably think it means (or what it means in standard English). Rather, IRC §6428B(g)(7) provides "a return of tax shall not be treated as filed until such return has been processed by the Internal Revenue Service." The wording indicates that this same "processed" rule will apply to those looking to get their 2020 return filed by the additional payment determination date.

The additional payment determination date is the earlier of

- The date that is 90 days after the 2020 calendar year filing deadline *or*

- September 1, 2021.[167]

The *2020 calendar year filing deadline* is determined after taking into account any period disregarded under §7508A if that period applies to substantially all returns for calendar year 2020. Basically, if the IRS again were to extend the filing season deadline to July 15, that date would become the date that begins the 90 day period rather than April 15.[168]

CHILD TAX CREDIT CHANGES FOR 2021 (ACT §9611)

Revisions are made to the child tax credit for 2021. So long as a taxpayer (or, in the case of a joint return, either spouse) has a place of abode in the United States over half of the year or is a bona fide resident of Puerto Rico, the rules under IRC §24(d) for a partially refundable credit are replaced by new, temporary rules found at IRC §24(i) for 2021 that create a fully refundable credit.

17-Year-Olds Can Be Qualifying Children

One long time feature of the Child Tax Credit has been the quirky rule that provided that 17-year-olds were not qualifying children for purposes of computing the child tax credit. For 2021 that will no longer be the case—a 17-year-old child, if otherwise a qualifying child, will serve to increase the child tax credit.[169]

166 IRC §6428B(g)(5)(B)(i)
167 IRC §6428B(g)(5)(B)(ii)
168 IRC §6428B(g)(5)(B)(iii)
169 IRC §24(i)(2)

Increase in the Per-Child Credit Amount to $3,000 ($3,600 for a Child Under Age 6)

The amount of the credit is also increased temporarily for 2021, rising from $1,000 to:

- $3,600 for any child that has not attained the age of 6 by the end of the calendar year and
- $3,000 for all other qualifying children.[170]

Revised Phase-Out of the Credit

ARPA looks to accelerate the phase-out of the increased credit, but still retain the slower phase-out found in the Tax Cuts and Jobs Act for the pre-ARPA credit amounts. This complicates the phase-out a bit.

In general, the 2021 child tax credit is phased out by $50 for each $1,000 over the *applicable threshold amount*.[171] The *applicable threshold amount* is:

- $150,000, in the case of a joint return or surviving spouse;
- $112,500, in the case of a head of household; and
- $75,000, in any other case.[172]

But, as noted, this reduction is limited by a separate provision. The amount of the above reduction is limited to the lesser of:

- the applicable credit increase amount, or
- 5 percent of the applicable phaseout threshold range.[173]

The first limit is the *applicable credit increase amount,* which is defined as the excess of:

- The amount of the child tax credit allowed at the higher 2021 rate without regard to either the standard reduction (found at IRC §24(b)) or the special 2021 reduction calculation described above *over*
- That amount of such credit so determined without regard to the higher-based $3,600/$3,000 rate.[174]

The second limit will be 5% of the *applicable credit phaseout range,* which is defined as:

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170 IRC §24(i)(3)
171 IRC §24(i)(4)(A)
172 IRC §24(i)(4)(B)
173 IRC §24(i)(4)(C)(i)
174 IRC §24(i)(4)(C)(ii)

- The higher, post TCJA threshold amount found at IRC §24(b), as modified by IRC §24(h)(3) ($400,000 for a married couple filing a joint return, $200,000 in any other case) *over*
- The special 2021 applicable threshold amount (the $150,000, $117,500 and $75,000 noted earlier).[175]

At this point the credit is then subjected to the old law reduction computation found at IRC §24(b).

EXAMPLE

The table below shows the computation for a taxpayer filing head of household, with 3 children, 1 of whom is under age 6 at December 31, 2021.

Child Tax Credit Example Under ARPA

Base Amount	
Children	3
Under age 6	1
Base Credit	**9,600**

ARPA Base 2021 Phase-Out (§24(i)(4)(A))	
Adjusted Gross Income	210,000
Filing Status	Head of Household
Applicable Threshold Amount	112,500
Amount over applicable threshold amount	97,500
$1,000/partial over threshold amount	98
Initial reduction	**4,900**

Applicable Credit Increase Amount	
New Base Credit	9,600
Regular Credit	3,000
Applicable Credit Increase Amount	**6,600**

175 IRC §24(i)(4)(C)

Applicable Phaseout Threshold Range	
Old law threshold amount	200,000
ARPA 2021 threshold amount	112,500
Difference	87,500
5% of the difference	**4,375**

Credit Before §24(b) Reduction	**5,225**

Original Phase-Out (§24(b))	
Adjusted Gross Income	210,000
Filing Status	Head of Household
Applicable Threshold Amount	200,000
Amount over applicable threshold amount	10,000
$1,000/partial over threshold amount	10
Final Reduction	**500**

Child Tax Credit - 2021	**4,725**

Advance Payment of Child Tax Credit

ARPA adds a new advance payment of a portion of a taxpayer's expected 2021 child tax credit over the period from July 1, 2021 to December 31, 2021.[176]

The taxpayer will be paid periodic equal payments (absent a modification to reflect an excess or deficit in prior payments) that will total the annual advance amount.[177]

Annual Advance Amount

The amount of the advance payment is an amount estimated by the IRS to be equal to 50% of the amount of the 2021 child tax credit that would be allowed if:

- The status of the taxpayer as a taxpayer as meeting the residency requirements is determined with respect to 2020 (the reference taxable year as described in the law);
- The taxpayer's modified adjusted gross income for 2021 is equal to the taxpayer's modified adjusted gross income for 2020;

[176] IRC §7527A(f)
[177] IRC §7527A(a)

- The only children of such taxpayer for such taxable year are qualifying children properly claimed on the taxpayer's 2020 income tax return, and

- The ages of such children (and the status of such children as qualifying children) are determined for such taxable year by taking into account the passage of time since 2020 (that is, adding one year to those ages).[178]

If a taxpayer has not filed a 2020 income tax return, then 2019 will be used instead.[179]

If the status of the taxpayer as eligible for the refundable credit cannot be established based on the information in the reference year return, the IRS will use information known to the agency to make the determination.[180]

If the IRS is aware of the death of a child as of the beginning of the year for which the estimate is being made (2021), then the child will not be taken into account in determining the advance payment amount.[181]

The use of a 50% calculation would appear to be based on the fact that the payments won't start until July, thus a taxpayer would only get these payments for half of the months during 2021.

The annual advance amount may be modified during the year to take into account:

- A return of tax filed by such taxpayer during such calendar year (and the taxable year to which such return relates may be taken into account as the reference taxable year), and

- Any other information provided by the taxpayer to the IRS which allows the agency to determine advance payments which, in the aggregate during any taxable year of the taxpayer, more closely total the agency's estimate of the amount treated as the child tax credit for 2021.[182]

In the case of such a modification of the annual advance amount, the IRS may adjust the amount of any periodic payment made after the date of such modification to properly take into account the amount by which any periodic payment made before such date was greater than or less than the amount that such payment would have been on the basis of the annual advance amount as so modified.[183]

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178 IRC §7527A(b)(1)
179 IRC §7527A(b)(2)
180 IRC §7527A(b)(4)
181 IRC §7527A(b)(5)
182 IRC §7527A(b)(3)(A)
183 IRC §7527A(b)(3)(B)

Online Information Portal

The IRS will be establish an online portal that will allow taxpayers to:

- Elect not to receive these advance payments, and
- Provide information to the IRS that would be relevant to a modification of the annual advance amount, including information regarding—
  - A change in the number of the taxpayer's qualifying children, including by reason of the birth of a child,
  - A change in the taxpayer's marital status,
  - A significant change in the taxpayer's income, and
  - Any other factor that the IRS may provide.[184]

IRS to Send Notice of Amounts Paid by January 31, 2022

No later than January 31, 2022 the IRS shall provide the taxpayer with a written notice which includes

- The taxpayer's taxpayer identity;
- The aggregate amount of such payments made to such taxpayer during such calendar year, and
- Such other information as the IRS determines appropriate.[185]

Reconciliation of the 2021 Child Tax Credit and the Advance Payment

The 2021 child tax credit will be reduced by the amount of the advance payments received by the taxpayer.[186] If a taxpayer received more in advance payments than the total amount of 2021 child tax credit the taxpayer qualified for, the excess will be treated as increase in tax for the year[187] but subject to relief under a safe harbor for certain taxpayers.

[184] IRC §7527A(c)
[185] IRC §7527A(d)
[186] IRC §24(j)(1)
[187] IRC §24(j)(2)(A)

Safe Harbor for Reduction in Repayment of Excess Advance Payment

To qualify for some level of relief under the safe harbor for reducing the repayment required, a taxpayer's modified taxable income must be less than 200% of the applicable income threshold described below.[188]

The applicable income threshold amounts are:

- $60,000 in the case of a joint return or surviving spouse;
- $50,000 in the case of a head of household, and
- $40,000 in any other case.[189]

The safe harbor amount is the product of:

- $2,000 times
- The excess (if any) of the number of qualified children taken into account in determining the annual advance amount with respect to months beginning in such taxable year, over the number of qualified children taken into account in determining the credit allowed under this section for such taxable year.[190]

The safe harbor amount is subject to phaseout for taxpayers with income above the applicable income threshold. The safe harbor is reduced by multiplying the safe harbor by the ratio of:

- The excess of the taxpayer's modified adjusted gross income over the applicable income threshold amount as compared to
- The applicable income threshold amount.[191]

Priority of the Advance Payment of the Recovery Rebate

While the law provides that the IRS is to establish this program as soon as practicable, the IRS is ordered to first ensure that the timing of setting up this program does not interfere with the payment of the advances on the 2021 recovery rebates under IRC §6428B(g).[192]

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188 IRC §24(j)(2)(B)(i)
189 IRC §24(j)(2)(B)(iii)
190 IRC §24(j)(2)(B)(iv)
191 IRC §24(j)(2)(B)(ii)
192 American Rescue Plan Act of 2021 §9611(c)(2)

Earned income Tax Credit Changes

ARPA makes a number of changes to the earning income tax credit under IRC §32.

Expansion of Credit for Taxpayers With No Qualifying Children

Prior to ARPA, a taxpayer who had no qualifying children had to have attained age 25 but not attained age 65 before the end of the taxable year to potentially be an eligible individual for purposes of the earned income tax credit.[193] However, for 2021 the minimum age will be lowered to:

- Age 24 for a specified student;
- Age 18 for a qualified former foster youth or a qualified homeless youth; and
- Age 19 for all other individuals.[194]

A *specified student* for 2021 is an individual who was an eligible student during at least 5 calendar months during the year.[195] An *eligible student* meets the requirements of section 484(a)(1) of the Higher Education Act of 1965 (20 U.S.C. 1091(a)(1)) and is carrying at least 1/2 the normal full-time work load for the course of study the student is pursuing.[196] The IRS is directed to use information provided with Forms 1098-T to check the status of individuals as specified students.[197]

A qualified former foster youth is an individual who:

- On or after the date that such individual attained age 14, was in foster care provided under the supervision or administration of an entity administering (or eligible to administer) a plan under part B or part E of title IV of the Social Security Act (without regard to whether Federal assistance was provided with respect to such child under such part E), and
- Provides (in such manner as the IRS may provide) consent for entities which administer a plan under part B or part E of title IV of the Social Security Act to disclose to the IRS information related to the status of such individual as a qualified former foster youth.[198]

A *qualified homeless youth* means, with respect to 2021, an individual who certifies, in a manner as provided by the IRS, that such individual is either an unaccompanied youth

[193] IRC §32(c)(1)(A)(ii)(II)
[194] IRC §32(n)(1)(B)
[195] IRC §32(n)(1)(C)
[196] IRC §25A(b)(3)
[197] American Rescue Plan Act of 2021 §9621(b)
[198] IRC §32(n)(1)(D)

who is a homeless child or youth, or is unaccompanied, at risk of homelessness, and self-supporting.[199]

The maximum age of 65 will also be eliminated for 2021.[200]

The credit percentage and phaseout percentage for a taxpayer with no qualifying children will rise in 2021 from 7.65% to 15.3%.[201]

Similarly, the earned income for an individual with no qualifying children will rise from $4,220 to $9,820 for 2021. The phaseout amount for 2021 for an individual with no qualifying children will rise from $5,280 to $11,610.[202] These dollar amounts are exempted from the inflation adjustment found at IRC §32(j).[203]

Repeal of Complete Bar on Claiming of the EITC by Individuals Who Do Not Include the TIN of Any Qualifying Child

Under the law prior to ARPA, no EITC was allowed to any individual who had one or more qualifying children if no qualifying child of such individual is taken into account due to a failure to provide an identification number.[204]

The provision is permanently removed from the law effective for years beginning after December 31, 2020.[205]

EITC Available to Certain Separated Spouses

Under the law prior to ARPA, the EITC could only be claimed if a married couple filed a joint return.[206]

ARPA allows a spouse to be treated as unmarried for purposes of claiming the EITC if three conditions are met. Such a qualified individual:

- Is married for federal tax purposes and does not file a joint return for the taxable year,
- Resides with a qualifying child of the individual for more than one-half of such taxable year, and

199 IRC §32(n)(1)(E)
200 IRC §32(n)(2)
201 IRC §32(n)(3)
202 IRC §32(n)(4)(A)
203 IRC §32(n)(4)(B)
204 IRC §32(c)(1)
205 American Rescue Plan Act of 2021 §9622
206 IRC §32(d) prior to amendment by the American Rescue Plan Act of 2021 §9623

- Either
  - During the last 6 months of such taxable year, does not have the same principal place of abode as the individual's spouse, or
  - Has a decree, instrument, or agreement (other than a decree of divorce) described in section 121(d)(3)(C) with respect to the individual's spouse and is not a member of the same household with the individual's spouse by the end of the taxable year.[207]

The change applies to tax years beginning after December 31, 2020.[208]

Modification of Disqualified Investment Income Test

For taxable years beginning after December 31, 2020, the disqualified investment income amount is increased substantially.

Under prior law, a taxpayer with disqualified investment income of more than $2,200 was barred from claiming the EITC.[209]

ARPA first boosts that number from $2,200 to $10,000.[210] The law then modifies the related inflation adjustment provisions to restart the inflation adjustment for this provision using calendar year 2020 as the base.[211]

This change takes effect for tax years beginning after December 31, 2020.[212]

Election to Use 2019 Earned Income in Lieu of 2021 Earned Income for Purposes of the EITC

If the earned income of the taxpayer for the taxpayer's first taxable year beginning in 2021 is less than the earned income of the taxpayer for the taxpayer's first taxable year beginning in 2019, at the election of the taxpayer the EITC may be determined by substituting such earned income for the taxpayer's first taxable year beginning in 2019 for the first taxable year beginning in 2021.[213]

In the case of a married couple filing a joint return, the earned income used shall both come from 2019 if this election is made.[214]

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207 IRC §32(d)(2)
208 American Rescue Plan Act of 2021 §9623
209 IRC §32(i)(1) prior to amendment by the American Rescue Plan Act of 2021 §9624
210 IRC §32(i)(1)
211 IRC §32(j)(1)
212 American Rescue Plan Act of 2021 §9624(c)
213 American Rescue Plan Act of 2021 §9626(a)
214 American Rescue Plan Act of 2021 §9626(b)

DEPENDENT CARE ASSISTANCE

A pair of changes are made in dependent care benefits under the IRC for 2021.

Refundability and Enhancement of the Child and Dependent Care Credit

The child and dependent care credit is expanded and made refundable for 2021 by the American Rescue Plan Act of 2021.

If a taxpayer (either spouse in the case of a joint return) has a principal place of abode in the United States for more than one-half of the taxable year in 2021, the child and dependent care credit found at IRC §21 will be treated as a refundable credit.[215]

The maximum dollar amount that can be taken into account for computing the credit is raised in 2021 to:

- $8,000 from $3,000 for one qualifying individual and
- $16,000 from $6,000 for two or more qualifying individuals.[216]

The credit begins at 50% of the creditable dollar amounts, up from 35% in other years.[217] Under the law in other years, the percentage is reduced by 1% (but not below 20%) for each $2,000 or fraction thereof that a taxpayer's adjusted gross income exceeded $15,000. For 2021 that phase down of the rate does not begin until a taxpayer's adjusted gross income exceeds $150,000.[218]

However, a complete phase-out now exists that begins to come in at the 1% for each $2,000 or fraction thereof by which a taxpayer's adjusted gross income exceeds $400,000.[219] Thus, the credit will phase out entirely when a taxpayer's adjusted gross income exceeds $438,000.

These rules apply solely to tax years beginning after December 31, 2020 and before January 1, 2022.[220]

Exclusion for Employer-Provided Dependent Care

For taxable years beginning after December 31, 2020 and before January 1, 2022 (generally calendar year 2021), the maximum amount that can be excluded from an employee's compensation under IRC §129(a)(2) is:

[215] IRC §21(g)(1)
[216] IRC §21(g)(2)(
[217] IRC §21(g)(3)(A)
[218] IRC §21(g)(3)(B)
[219] IRC §21(g)(4)(
[220] IRC §21(g)

- $10,500 except for
- Married individuals filing a separate return where the maximum exclusion is reduced to $5,250.[221]

Dependent care and affected cafeteria plans are allowed to operate consistent with these rules so long as a retroactive amendment implementing this provision is adopted by no later than the last day of the plan year where the amendment is effective.[222]

Credit for Sick Leave for Certain Self-Employed Persons

A refundable credit[223] similar to the credit for paid sick leave is available for self-employed. The credit only covers days during the period:

- Beginning on April 1, 2021 and
- Ending on September 30, 2021.[224]

Qualification as a Self-Employed Individual

In order to claim this credit, the individual must be an individual who:

- Regularly carries on any trade or business within the meaning of IRC §1402 (the definition of income from self-employment) of the Internal Revenue Code of 1986, and
- Would be entitled to receive paid leave during the taxable year pursuant to the Emergency Paid Sick Leave Act if—
  - The individual were an employee of an employer (other than himself or herself), and
  - Such Act applied after March 31, 2021.[225]

The law provides that no credit will be allowed unless the taxpayer maintains such documentation as the IRS may prescribe to establish such individual as an eligible self-employed individual.[226] The mandatory documentation standard bars the taxpayer from trying to argue for qualification based on the argument that even lacking the documentation, the taxpayer has reasonably established qualification (*Cohan v. Commissioner*, CA2 (1930) 39 F. 2d 540).

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[221] IRC §129(a)(2)(D)
[222] American Rescue Plan Act of 2021 §9632(c)
[223] American Rescue Plan Act of 2021 §9642(d)
[224] American Rescue Plan Act of 2021 §9642(f)
[225] American Rescue Plan Act of 2021 §9642(b)(1)
[226] American Rescue Plan Act of 2021 §9642(e)(1)

Thus, advisers need to inquire of taxpayers if they have the documentation that the IRS may require in published guidance when they attempt to claim this credit.

Events Qualifying for the Credit

The same list of situations that qualify for a credit as appear for the payroll tax credit apply here. To be entitled the credit, an individual must be unable to work or telework due to one of the following issues:

- The individual is subject to a Federal, State, or local quarantine or isolation order related to COVID-19.

- The individual has been advised by a health care provider to self-quarantine due to concerns related to COVID-19.

- Any of the following apply to the employee

  - The individual is experiencing symptoms of COVID-19 and seeking a medical diagnosis,[227]

  - The individual is seeking or awaiting the results of a diagnostic test for, or a medical diagnosis of, COVID-19 and such employee has been exposed to COVID-19 or the employee's employer has requested such test or diagnosis, or

  - The individual is obtaining immunization related to COVID-19 or recovering from any injury, disability, illness, or condition related to such immunization.[228]

Note that the las two options for the credit do not take effect until quarters beginning after March 31, 2021, so self-employed individuals obtaining a vaccine will not be given a credit for any time taken to obtain that vaccination before April.[229]

- The individual is caring for another individual:

  - Who is subject to Federal, State, or local quarantine or isolation order related to COVID-19 or

  - Who has been advised by a health care provider to self-quarantine due to concerns related to COVID-19

- The individual is caring for a son or daughter of such employee if the school or place of care of the son or daughter has been closed, or the child care provider of such son or daughter is unavailable, due to COVID-19 precautions.

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227 Section 5102(a) of the Emergency Paid Sick Leave Act
228 American Rescue Plan Act of 2021 §9642(b)(2)(A)
229 American Rescue Plan Act of 2021 §9642(f)

- The individual is experiencing any other substantially similar condition specified by the Secretary of Health and Human Services in consultation with the Secretary of the Treasury and the Secretary of Labor. [230]

Qualified Sick Leave Equivalent Amount

The amount of the credit is the *qualified sick leave equivalent amount*. That means, with regard to the self-employed individual, an amount equal to:

- The number of days during the taxable year (but not more than 10) that the individual is unable to perform services in any trade or business referred to in section 1402 of the Internal Revenue Code of 1986 for a reason with respect to which such individual would be entitled to receive sick leave if he/she were an employee, multiplied by

- the lesser of—

  - $200 ($511 in the case of any day of paid sick time described the first three general categories), or

  - 67 percent (100 percent in the case of any day of paid sick time described in the first three categories) of the average daily self-employment income of the individual for the taxable year.[231]

Average daily self-employment income is an amount equal to:

- The net earnings from self-employment of the individual for the taxable year,

- divided by 260.[232]

At the taxpayer's election, the net self-employment income of the prior year, rather than the current year, may be used in the above calculation.[233]

The taxpayer may elect, in a manner outlined by the IRS, not to take a qualified day into account for this credit.[234]

CREDIT FOR FAMILY LEAVE OF SELF-EMPLOYED INDIVIDUALS

As with the credit for employees, a similar credit for family leave exists for self-employed individuals.

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[230] American Rescue Plan Act of 2021 §9642(b)(2)(A)
[231] American Rescue Plan Act of 2021 §9643(c)(1)
[232] American Rescue Plan Act of 2021 §9643(c)(1)
[233] American Rescue Plan Act of 2021 §9643(c)(2)
[234] American Rescue Plan Act of 2021 §9643(c)(4)

As with the credit for sick pay, this credit looks to see if the self-employed person, had he/she been employed, would have qualified for the family leave credit that is part of the American Rescue Plan Act of 2021.

The credit only covers days during the period:

- Beginning on April 1, 2021 and
- Ending on September 30, 2021.[235]

Situations Where Family Leave is Available

- Due to a need for leave to care for the son or daughter under 18 years of age of such employee if
  - The school or place of care has been closed, or
  - The child care provider of such son or daughter is unavailable, due to a public health emergency, *or*
- The employee is seeking or awaiting the results of a diagnostic test for, or a medical diagnosis of, COVID-19 and such employee has been exposed to COVID-19 or the employee's employer has requested such test or diagnosis, or
- The employee is obtaining immunization related to COVID-19 or recovering from any injury, disability, illness, or condition related to such immunization.[236]

The need to have 10 days of "unpaid" family leave days is also removed from the credit.[237]

Qualified Family Leave Equivalent Amount

The credit is equal to the self-employed person's *qualified family leave equivalent amount*. That is defined as an amount equal to:

- The number of days (not to exceed 60) during the taxable year that the individual is unable to perform services in any trade or business referred to in section 1402 of the Internal Revenue Code of 1986 for a reason with respect to which such individual would be entitled to receive paid family leave, multiplied by
- The lesser of:

[235] American Rescue Plan Act of 2021 §9643(f)
[236] American Rescue Plan Act of 2021 §9643(b)(2)(A), Section 110(a)(2)(A) of the Family and Medical Leave Act of 1993
[237] American Rescue Plan Act of 2021 §9643(b)(2)(B)(ii)

– 67 percent of the average daily self-employment income of the individual for the taxable year, or

– $200.[238]

Average daily self-employment income is an amount equal to:

- The net earnings from self-employment of the individual for the taxable year, divided by

- 260.[239]

At the taxpayer's election, the net self-employment income of the prior year, rather than the current year, may be used in the above calculation.[240]

A day taken into account as qualified sick leave is not taken into account in determining the qualified family leave equivalent amount.[241]

Extension of the Employee Retention Credit

ARPA extends the refundable employee retention credit, adding another set of new provisions for the credit that will take effect on July 1, 2021.[242] The credit is extended from July 1, 2021 to December 31, 2021.[243]

The credit is equal to 70% of qualified wages paid by an employer with respect to each employee of the employer for the calendar quarter.[244] Qualified wages includes amounts paid by the employer to provide and maintain a group health plan, but only to the extent such amounts are excluded from the wages of the employee by IRC §106(a).[245]

Such health care costs shall be treated as paid with respect to any employee (and with respect to any period) to the extent that such amounts are properly allocable to such employee (and to such period) in such manner as the IRS may prescribe. Except as otherwise provided by the IRS, such allocation shall be treated as properly made if made on the basis of being pro rata among periods of coverage.[246]

[238] American Rescue Plan Act of 2021 §9643(c)(1)
[239] American Rescue Plan Act of 2021 §9643(c)(2)
[240] American Rescue Plan Act of 2021 §9643(c)(3)
[241] American Rescue Plan Act of 2021 §9643(c)(4)
[242] American Rescue Plan Act of 2021 §9651(d)
[243] IRC §3131(n)
[244] IRC §3134(a)
[245] IRC §3134(c)(4)(B)(i)
[246] IRC §3134(c)(4)(B)(ii)

Generally, the credit is not available to the Government of the United States, the government of any State or political subdivision thereof, or any agency or instrumentality of any of those entities.[247] However, the law contains exceptions if the entity in question

- Qualifies under IRC §501(c)(1) and is exempt from tax under IRC §501(a) or
- Such a governmental entity is
  - A college or university or
  - The principal purpose or function of such entity is providing medical or hospital care.[248]

Limit on Wages Taken Into Account

The law provides the following limits on wages taken into account in computing the credit:

- The amount of qualified wages with respect to any employee that may be taken into account for the credit by the eligible employer for any calendar quarter shall not exceed $10,000, and
- In the case of an eligible employer which is a *recovery startup business*, the amount of the credit allowed (after application of the $10,000 of wages per employee limit) for any calendar quarter shall not exceed $50,000.[249]

Eligible Employer

An eligible employer is any employer:

- Which was carrying on a trade or business during the calendar quarter for which the credit is determined, and
- With respect to any calendar quarter, for which:
  - The operation of the trade or business is fully or partially suspended during the calendar quarter due to orders from an appropriate governmental authority limiting commerce, travel, or group meetings (for commercial, social, religious, or other purposes) due to the coronavirus disease 2019 (COVID-19),
  - The gross receipts (within the meaning of section 448(c) (the small business cash basis account method eligibility receipts test) of such employer for such

[247] IRC §3134(f)(1)
[248] IRC §3134(f)(2)
[249] IRC §3134(b)(1)

calendar quarter are less than 80 percent of the gross receipts of such employer for the same calendar quarter in calendar year 2019 (If an employer was not in existence as of the beginning of the quarter in question in 2019, the quarter in 2020 will be used instead)[250], or

- The employer is a recovery startup business.[251]

The employer may also elect to use an alternate quarter by applying the 80% revenue test on the immediately preceding quarter[252] and then comparing that quarter with the corresponding quarter in 2019 (or 2020 if appropriate).[253]

The election is to be made at such time and in such a manner as the IRS may prescribe.[254]

Tax-Exempt Organizations

For a tax-exempt organization the test is changed slightly, being an eligible employer by

- Applying the entire operations of the organization to the trade or business references in the main definition and

- Treating any reference to gross receipts as referring to such gross receipts within the meaning of IRC §6033.[255]

Recovery Start-Up Businesses

A new addition to the ERC found in ARPA is the category of *recovery start-up business*. A *recovery startup business* is any employer:

- Which began carrying on any trade or business after February 15, 2020 (previously such employers could not qualify for the ERC),

- For which the average annual gross receipts of such employer (as determined under rules similar to the rules under section 448(c)(3)) for the 3-taxable-year period ending with the taxable year which precedes the calendar quarter for which the credit is determined under subsection (a) does not exceed $1,000,000, and

- Which, with respect to such calendar quarter, is not described in subclause (I) (full or partial suspension) or (II) (reduction of revenue) of paragraph (2)(A)(ii).[256]

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[250] IRC §3134(c)(2)(A)
[251] IRC §3134(c)(2)(A)
[252] IRC §3134(c)(2)(B)(i)(I)
[253] IRC §3134(c)(2)(B)(i)(II), (ii)
[254] IRC §3134(c)(2)(B)
[255] IRC §3134(c)(2)(C)
[256] IRC §3134(c)(5)

Note that the new ERC found at IRC §3134 no longer requires a business to be in existence on February 15, 2020, so a business started after that date can qualify under one of the two qualification methods that were in the pre-July 1 2022 ERC. If an otherwise qualified *recovery startup business* meets either of those tests, it is treated under those provisions.

Qualified Wages

As was true in the 2022 version of the Employee Retention Credit found in Taxpayer Certainty and Disaster Relief Act of 2020 §207, the ARPA post-June 30, 2021 version of the ERC generally greatly limits the wages that count for an employer who had more than 500 employees in 2019.

In general, the rule reads as follows:

- In the case of an eligible employer for which the average number of full-time employees (within the meaning of IRC §4980H (the ACA shared responsibility payment provision)) employed by such eligible employer during 2019 was greater than 500, wages paid by such eligible employer with respect to which an employee is not providing services due to a qualified decrease in revenue or a full or partial suspension, or

- In the case of an eligible employer for which the average number of full-time employees (within the meaning of section 4980H) employed by such eligible employer during 2019 was not greater than 500—

  - With respect to an employer operating under a full or partial suspension, wages paid by such eligible employer with respect to an employee during any period of full or partial suspension, or

  - With respect to an eligible employer with a qualified decrease in revenue, wages paid by such eligible employer with respect to an employee during such quarter.[257]

If an employer was not in existence in 2019, the above rules are applied by substituting 2020 for 2019.[258]

In the new ERC, large employers (those who had more than 500 employees in 2019) can qualify to count all employees (not just those not providing services) for the credit if the business qualifies as a *severely financially distressed employer*.[259]

[257] IRC §3134(c)(3)(A)
[258] IRC §3134(c)(3)(B)
[259] IRC §3134(c)(3)(C)(i)

A *severely financially distressed employer* is an employer with a decrease in revenue of more than 90% rather than more than 20% in the applicable quarter.[260]

Exclusion for Certain Wages

Qualified wages for purposes of the ERC does not include wages taken into account under:

- 41 (research credit),
- 45A (Indian employment credit),
- 45P (Employer wage credit for employees who are active-duty members of the uniformed services),
- 45S (Employer credit for paid family and medical leave),
- 51 (Work opportunity credit),
- 1396 (Empowerment zone employment credit)
- 3131 (Payroll tax credit for sick pay), and
- 3132 (Payroll tax credit for paid family leave).[261]

Similar rules to those found at IRC §280C(a) (related to limits on employment credits) apply as well to situations where credits are being claimed under IRC §§45A(a), 45P(a), 45S(a), 51(a), and 1396(a).[262]

Related Party

One area that has created significant confusion with the earlier versions of the credit is found in IRC §3134(e), specifically the clause that states the rules similar to the rules of IRC §51(i)(1) will apply to this credit.

IRC §51(i)(1) reads as follows:

> Related individuals
>
> No wages shall be taken into account under subsection (a) with respect to an individual who—
>
> (A) bears any of the relationships described in subparagraphs (A) through (G) of section 152(d)(2) to the taxpayer, or, if the taxpayer is

[260] IRC §3134(c)(3)(C)(ii)
[261] IRC §3134(c)(3)(D)
[262] IRC §3134(e)

> a corporation, *to an individual who owns*, directly or *indirectly*, *more than 50 percent* in value of the outstanding stock of the corporation, or, if the taxpayer is an entity other than a corporation, to any *individual who owns*, directly or *indirectly*, *more than 50 percent of the capital and profits interests* in the entity (determined with the application of section 267(c)),
>
> (B) if the taxpayer is an estate or trust, is a grantor, beneficiary, or fiduciary of the estate or trust, or is an individual who bears any of the relationships described in subparagraphs (A) through (G) of section 152(d)(2) to a grantor, beneficiary, or fiduciary of the estate or trust, or
>
> (C) is a dependent (described in section 152(d)(2)(H)) of the taxpayer, or, if the taxpayer is a corporation, of an individual described in subparagraph (A), or, if the taxpayer is an estate or trust, of a grantor, beneficiary, or fiduciary of the estate or trust.

In the FAQ on the IRS website related to the ERC,[263] the IRS provides the following guidance on what parties the above restrictions apply to:

> Wages paid to related individuals, as defined by section 51(i)(1) of the Internal Revenue Code (the "Code"), are not taken into account for purposes of the Employee Retention Credit. A related individual is any employee who has of any of the following relationships to the employee's employer who is an individual:
>
> - A child or a descendant of a child;
> - A brother, sister, stepbrother, or stepsister;
> - The father or mother, or an ancestor of either;
> - A stepfather or stepmother;
> - A niece or nephew;
> - An aunt or uncle;
> - A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.
>
> In addition, if the Eligible Employer is a corporation, then a related individual is any person that bears a relationship described above with

[263] "COVID-19-Related Employee Retention Credits: Determining Qualified Wages FAQs," Question 59, IRS Website, March 1, 2021, https://www.irs.gov/newsroom/covid-19-related-employee-retention-credits-determining-qualified-wages-faqs (retrieved March 12, 2021)

> an individual owning, directly or indirectly, more than 50 percent in value of the outstanding stock of the corporation.
>
> If the Eligible Employer is an entity other than a corporation, then a related individual is any person that bears a relationship described above with an individual owning, directly or indirectly, more than 50 percent of the capital and profits interests in the entity.
>
> If the Eligible Employer is an estate or trust, then a related individual includes a grantor, beneficiary, or fiduciary of the estate or trust, or any person that bears a relationship described above with an individual who is a grantor, beneficiary, or fiduciary of the estate or trust.[264]

The problem arises with the highlighted *indirect* ownership issue. Section 51 itself does not define "indirectly", nor do the regulations under the provision, and in various other contexts where it is used it often has special definitions applied. But in most contexts, ownership by close family members is deemed to be such indirect ownership of the stock.

So let's assume that a 100% shareholder of a corporation has a daughter. The law and the IRS guidance makes it very clear that her wages would not qualify, as she is a child of the person who has control of the corporation—holding more than 50% of the stock.

But it also appears that she indirectly owns 100% of the stock. In which case, her parents would be barred from having their wages count as well. And, in almost all cases, a controlling shareholder is going to have some related party that would cause the problem to splash back onto them, making them ineligible—at least if this view is correct.

But, it may be objected to, if this is what Congress meant to happen, then why didn't they simply say more than 50% owners could not qualify for the work opportunity credit under IRC §51—and, now by reference, the ERC? This seems a rather odd way to accomplish this goal, when Congress could easily have simply said that controlling interest holders and those related to the same cannot claim the credit.

But before you get comfortable with that view, be aware that the *Joint Committee on Taxation Technical Explanation of the Protecting Americans From Tax Hikes Act of 2015*, a law that made some changes to the classes that qualified for the work opportunity credit, states rather matter of factly that "[n]o credit is allowed for wages paid to an individual who is a more than fifty-percent owner of the entity."[265] The statement is

264 "COVID-19-Related Employee Retention Credits: Determining Qualified Wages FAQs," Question 59, IRS Website, March 1, 2021

265 *Joint Committee on Taxation Technical Explanation of the Protecting Americans From Tax Hikes Act of 2015*. JCX-144-15, PL 114-113, December 18, 2015, p. 59, https://www.jct.gov/CMSPages/GetFile.aspx?guid=3f362419-0dfe-4844-8906-d6e090c5b822 (retrieved March 12, 2021)

made in such a matter of fact manner that it seems the author believed that was plainly clear to anyone reading the law.

So where does this leave us? Not in a good position. My own reading is that the most plausible reading is that a controlling owner normally cannot qualify for the credit due the splashback effect where he/she becomes a disqualified person due to the indirect ownership of a party he/she is related to. That position is consistent with that 2015 committee report. And it certainly seems that if anyone is an indirect owner, the daughter of the controlling shareholder would be such a person—and I can't come up with an obvious way to exclude her.

But I'm also terribly uncomfortable with this rather unnecessarily roundabout way that this answer is arrived at, when it would have been simple for Congress to have just said it in the law the way the Joint Committee report worded it. Ultimately, absent specific IRS judgment, this is a matter of professional judgment.

Election Not to Take Certain Wages Into Account

A taxpayer can elect not to take certain wages that otherwise would qualify into account for the ERC at such time and manner as the IRS may prescribe.[266] Such an election would likely be made to allow the wages to be used for another benefit that cannot be claimed on the same wages as those used for the ERC, such as for forgiveness of a Paycheck Protection Program loan.

Coordination with Other COVID Relief Programs

The credit does not apply to so much of qualified sick leave wages taken into account as payroll costs in connection with

- A covered loan under section 7(a)(37) (second draw PPP loan) or 7A (first draw PPP loan) of the Small Business Act (the IRS will issue guidance for cases where such forgiveness is denied),[267]

- A grant under the Shuttered Venue Operation Grant (Section 324 of the Economic Aid to Hard-Hit Small Businesses, Non-Profits, and Venues Act), or

- a Restaurant Revitalization Grant under section 5003 of the American Rescue Plan Act of 2021.[268]

Advance Payments

A provision added to the ERC for 2021 allowing small employers to elect to obtain an advance payment of the ERC has been extended in ARPA. For these purposes a small

[266] IRC §3134(g)
[267] IRC §3134(h)(2)
[268] IRC §3134(h)(1)

employer is one who did not employ more than 500 employees in 2019—larger employers are barred from receiving such payments.[269]

The advance credit is not to exceed 70% of the average quarterly wages paid by the employer in 2019.[270]

Special rules apply to seasonal employers and those not in existence in 2019. For seasonal employers the special provision provides:

> In the case of any employer who employs seasonal workers (as defined in section 45R(d)(5)(B)), the employer may elect to apply subparagraph (A) by substituting 'the wages for the calendar quarter in 2019 which corresponds to the calendar quarter to which the election relates' for 'the average quarterly wages paid by the employer in calendar year 2019'.[271]

For employers not in existence in 2019, the above rules shall be applied by substituting 2020 for 2019 as the base period being evaluated for the advance payment amount.[272]

At the end of the quarter the credit will be reconciled with the advance payments:

- The amount of credit that would be allowed for the quarter shall be reduced (but not below zero) by the aggregate advance payment allowed to the taxpayer. Any failure to so reduce the credit shall be treated as arising out of a mathematical or clerical error and assessed according to the math error rules.

- If the advance payments to a taxpayer for a calendar quarter exceed the credit allowed for the quarter, the tax imposed under section 3111(b) (Medicare tax on the employer) or so much of the tax imposed under section 3221(a) as is attributable to the rate in effect under section 3111(b) (RRTA Medicare tax equivalent) for the calendar quarter shall be increased by the amount of such excess. In effect, the employer pays back the excess.[273]

Extended Period to Assess Tax Under This Provision

The time period for the IRS to assess taxes related to this provision will not expire before five years from the date that is the later of:

- The date on which the original return which includes the calendar quarter with respect to which such credit is determined is filed, or

[269] IRC §3134(j)(2)(A)
[270] IRC §3134(j)(2)(A)
[271] IRC §3134(j)(2)(B)
[272] IRC §3134(j)(2)(C)
[273] IRC §3134(j)(3)

- The date on which such return is treated as filed under IRC §6501(b)(2).[274]

PREMIUM TAX CREDIT REVISIONS

A number of revisions are being made to the premium tax credit found at IRC §36B

Expansion of Premium Assistance

ARPA liberalizes the table for premium tax credit amounts, effectively removing the 400% of the poverty line household income limit. The revised table for the *applicable percentage* of household income (used to set the maximum the taxpayer is expected to pay for the applicable second lowest cost silver plan.

For taxable years beginning in 2021 or 2022 the 400% cap on obtaining a premium tax credit is removed

In the case of household income (expressed as a percent of poverty line) within the following income tier:	The initial premium percentage is—	The final premium percentage is—
Up to 150.0 percent	0.0	0.0
150.0 percent up to 200.0 percent	0.0	2.0
200.0 percent up to 250.0 percent	2.0	4.0
250.0 percent up to 300.0 percent	4.0	6.0
300.0 percent up to 400.0 percent	6.0	8.5
400.0 percent and higher	8.5	8.5

Special Rule for Taxpayers Receiving Unemployment in 2021

If a taxpayer has received or is approved to receive unemployment compensation for any week beginning during 2021, for the taxable year when the week begins:

- Such taxpayer shall be treated as an applicable taxpayer (that is, eligible to claim the premium tax credit), and
- There shall not be taken into account any household income of the taxpayer in excess of 133 percent of the poverty line for a family of the size involved.[275]

Despite this provision, if the taxpayer is married the taxpayer will still be required to file a joint return to be treated as an applicable taxpayer.[276]

[274] IRC §3134(l)
[275] IRC §36B(g)(1)
[276] IRC §36B(g)(4), (c)(1)(C)

The taxpayer will be required to provide a self-attestation of, and documentation that the IRS may require, that demonstrates such receipt or approval in order to make use of this provision.[277]

For purposes of applying the test for employer-sponsored minimum coverage under IRC §36B(c)(2)(C)(i)(II) to see if the employer's required contribution exceeds the appropriate percentage of income, the 133% of the poverty line rule above will not be applied. The same will be true for the test for affordable coverage for qualified small employer health reimbursement arrangements under IRC §36B(c)(4)(C)(ii).[278]

MISCELLANEOUS PROVISIONS

The tax provisions in ARPA end with a number of miscellaneous provisions.

Repeal of the Election to Allocate Interest, etc. on a Worldwide Basis

The election found at IRC §864(f) to allocate interest, etc. on a worldwide basis is repealed effective for tax years beginning after December 31, 2020.[279]

Tax Treatment of Targeted EIDL Advances

ARPA brings the tax treatment of targeted EIDL advances, added by section 331 of the Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act into line with the various other federal assistance programs enacted related to COVID-19. APRA provides that:

- Amounts received from the Administrator of the Small Business Administration in the form of a targeted EIDL advance under shall not be included in the gross income of the person that receives such amounts,
- No deduction shall be denied, no tax attribute shall be reduced, and no basis increase shall be denied, by reason of the exclusion from gross income of the advance,
- In the case of a partnership or S corporation that receives such amounts—
  - Any amount excluded from income from the advance shall be treated as tax exempt income for purposes of sections 705 and 1366 of the Internal Revenue Code of 1986, and

277 IRC §36B(g)(3)
278 IRC §36B(g)(4)(B)
279 American Rescue Plan Act of 2021 §9671

- The IRS shall prescribe rules for determining a partner's distributive share of that tax exempt income for purposes of section 705 of the Internal Revenue Code of 1986.[280]

Tax Treatment of Restaurant Revitalization Grants

A new assistance program added by ARPA involves restaurant revitalization grants, and this program got its own similar tax treatment provision. ARPA provides that:

- Amounts received from the Administrator of the Small Business Administration in the form of a restaurant revitalization grant shall not be included in the gross income of the person that receives such amounts,

- No deduction shall be denied, no tax attribute shall be reduced, and no basis increase shall be denied, by reason of the exclusion from gross income of the grant, and

- In the case of a partnership or S corporation that receives such amounts—

  - Except as otherwise provided by IRS, any amount excluded from income shall be treated as tax-exempt income for purposes of sections 705 and 1366 of the Internal Revenue Code of 1986, and

  - The IRS shall prescribe rules for determining a partner's distributive share of any such tax-exempt income for purposes of section 705 of the Internal Revenue Code of 1986.

Modification of Reporting of Third-Party Network Transactions

ARPA will serve to increase the reporting of third-party network transactions by changing the de minimis exception. Under prior law, an information return wasn't required unless:

- The amount which would otherwise be reported under subsection (a)(2) with respect to such transactions exceeds $20,000, and

- The aggregate number of such transactions exceeds 200.[281]

ARPA revises the de minimis exception to provide that a third-party settlement organization shall not be required to report any information with respect to third-party network transactions of any participating payee if the amount that would otherwise be reported with respect to such transactions does not exceed $600.[282]

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[280] American Rescue Plan Act of 2021 §9672

[281] IRC §6050W(e) prior to amendment by the American Rescue Plan Act of 2021 §9674

[282] IRC §6050W(e) after amendment by the American Rescue Plan Act of 2021 §9674

However, the law is clarified to provide that reporting is not required on transactions that are not for goods or services.[283]

The new provision applies only to transactions after March 11, 2021 for calendar years beginning after December 31, 2021.[284]

Exclusion from Income of Certain Student Debt Forgiveness

ARPA rewrites IRC §108(f)(5), removing the provision that dealt solely with discharges on account of death or disability of such loans and replacing the section with a much broader exclusion. The new rule offers a broad exclusion from income for certain discharges of student debt in 2021 through 2025.

Under the new provision, gross income does not include income from the discharge (in whole or in part) after December 31, 2020 and before January 1, 2026 of:

- Any loan provided expressly for postsecondary educational expenses, regardless of whether provided through the educational institution or directly to the borrower, if such loan was made, insured, or guaranteed by—
  - the United States, or an instrumentality or agency thereof,
  - A State, territory, or possession of the United States, or the District of Columbia, or any political subdivision thereof, or
  - An eligible educational institution,
- Any private education loan (as defined in section 140(a)(7) of the Truth in Lending Act),
- Any loan made by any educational organization described in section 170(b)(1)(A)(ii) (an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on) if such loan is made—
  - Pursuant to an agreement with the education institution or any private education lender (as defined in section 140(a) of the Truth in Lending Act) under which the funds from which the loan was made were provided to such educational organization,
  - Pursuant to a program of such educational organization which is designed to encourage its students to serve in occupations with unmet needs or in areas with unmet needs and under which the services provided by the students (or

[283] IRC §6050W(c)(3)
[284] American Rescue Plan Act of 2021 §9674(c)

former students) are for or under the direction of a governmental unit or an organization described in section 501(c)(3) and exempt from tax under section 501(a), or

- Any loan made by an educational organization described in section 170(b)(1)(A)(ii) (an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on) or by an organization exempt from tax under section 501(a) to refinance a loan to an individual to assist the individual in attending any such educational organization but only if the refinancing loan is pursuant to a program of the refinancing organization which is designed as described the sub-bullet item immediately above.[285]

The exclusion will not apply to the discharge of a loan made by an educational institution or made by a private education lender if the discharge is on account of services performed for either such organization or for such private education lender.[286]

[285] IRC §108(f)(5)
[286] IRC §108(f)(5)

NOTES

Unit 5

Infrastructure Investment and Jobs Act (IIJA)

The House of Representatives on November 5, 2021 passed the Infrastructure Investment and Jobs Act, accepting the amendments the Senate had made to the bill.

Although not primarily a tax bill, the Infrastructure Investment and Jobs Act (IIJA) does contain some provisions that have a tax impact.

For each provision, the effective date of the provision is noted. For those items whose effective date is tied to the date of enactment. which was November 15, 2021, the date that the President signed the bill.

RELIEF FOR TAXPAYERS AFFECTED BY DISASTERS OR OTHER CRITICAL EVENTS

The Act adds provisions for taxpayers impacted by disasters and other critical events.

Modification of Automatic Extension of Certain Deadlines in the Case of Taxpayers Affected by Federally Declared Disasters (IRC §7508A, Act §80501)

Effective date: The amendment made by this section shall apply to federally declared disasters declared after November 15, 2021.[287]

The special rules extending the time to perform certain tax acts under IRC §7508A are modified to automatically provide that the time to perform the following acts for the period from the earliest incident date for the disaster until the date which is 60 days

[287] Infrastructure Investment and Jobs Act §80501(b)

after the later of the earliest incident date for the disaster or the date the disaster declaration is declared:

- Filing any return of income, estate, gift, employment, or excise tax;
- Payment of any income, estate, gift, employment, or excise tax or any installment thereof or of any other liability to the United States in respect thereof;
- Filing a petition with the Tax Court, or filing a notice of appeal from a decision of the Tax Court;
- Allowance of a credit or refund of any tax;
- Filing a claim for credit or refund of any tax; and
- Bringing suit upon any such claim for credit or refund.[288]

If there are multiple declarations relating to a disaster area which are issued within a 60-day period, a separate period shall be determined with respect to each such declaration.[289]

The Act also revises the definition of a disaster area for purposes of IRC §7508A. Previously, the provision referenced the definition found at IRC §165(i)(5)(B), but it now will use the following definition specific to this provision:

> (3) DISASTER AREA.—For purposes of this subsection, the term 'disaster area' means an area in which a major disaster for which the President provides financial assistance under section 408 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act (42 U.S.C. 5174) occurs.[290]

Modifications of Rules for Postponing Certain Acts by Reason of Service in Combat Zone or Contingency Operation (IRC §7508, Act §80502)

Effective date: The amendments made by this section shall apply to any period for performing an act which has not expired before the date of the enactment of this Act.

[288] IRC §7508A(d)(1)(B) as revised by the Infrastructure Investment and Jobs Act §80501; IRC §7508(a)(1)(A)-(F)) as revised by the Infrastructure Investment and Jobs Act
[289] IRC §7508A(d)(g) as revised by the Infrastructure Investment and Jobs Act §80501
[290] IRC §7508A(d)(3) as revised by the Infrastructure Investment and Jobs Act §80501

The Act changes the text for the Tax Court related items that are granted an extension of time for those serving in a combat zone. Prior to the change, the provision read:

> (C) Filing a petition with the Tax Court for redetermination of a deficiency, or for review of a decision rendered by the Tax Court;[291]

The new language removes the "review" language and specifically limits the extension of time to filing a notice of appeal from a decision of the Tax Court:

> (C) Filing a petition with the Tax Court, or filing a notice of appeal from a decision of the Tax Court;[292]

Similarly, the Act clarifies that the extension of time also gives the United States the same additional time in respect to filing a suit recovering an erroneous refund in addition to a suit in respect of a tax liability.[293]

Tolling of Time for Filing a Petition with the Tax Court. (IRC §7451, Act §80503)

Effective date.—The amendments made by this section shall apply to petitions required to be timely filed (determined without regard to the amendments made by this section) after November 15, 2021.

The Act changes the title of IRC §7451 from "Fee for filing petition" to "Petitions." The change in title is made as the provision is revised to, in addition to authorizing the Tax Court to charge a fee for filing a petition, to add a new tolling provision when the filing location is inaccessible or otherwise unavailable to the public on the date the petition is due. The new provision, found at new IRC §7451(b), reads:

> (b) Tolling of time in certain cases.—
>
> (1) IN GENERAL.—Notwithstanding any other provision of this title, in any case (including by reason of a lapse in appropriations) in which a filing location is inaccessible or otherwise unavailable to the general public on the date a petition is due, the relevant time period for filing such petition shall be tolled for the number of days within the period of inaccessibility plus an additional 14 days
>
> (2) FILING LOCATION.—For purposes of this subsection, the term 'filing location' means—
>
> > (A) the office of the clerk of the Tax Court, or

[291] IRC §7508(a)(1)(C) before revision by the Infrastructure Investment and Jobs Act
[292] IRC §7508(a)(1)(C) after revision by the Infrastructure Investment and Jobs Act
[293] IRC §7508(a)(1)(J) after revision by the Infrastructure Investment and Jobs Act

(B) any on-line portal made available by the Tax Court for electronic filing of petitions.[294]

Authority to Postpone Certain Tax Deadlines by Reason of Significant Fires. (IRC §7508A, Act §8054)

Effective date.—The amendments made by this section shall apply to fires for which assistance is provided after the date of the enactment of this Act.

The Act adds a "significant fire" to the items that triggered the relief provisions for performing certain acts found in IRC §7508A in addition to a disaster or terroristic or military action.[295]

The Act defines a *significant fire* as "any fire with respect to which assistance is provided under section 420 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act."[296]

OTHER TAX RELATED PROVISIONS

The Act also contained various other tax related provisions.

Modification of Tax Treatment of Contributions to the Capital of a Corporation. (IRC §118, Act §80601)

Effective date.—The amendments made by this section shall apply to contributions made after December 31, 2020.[297]

IIJA adds a special exclusion from income for qualified contributions to the capital of a corporation for certain regulated public water and sewage disposal utilities.[298]

A *regulated public utility* for these purposes means a corporation engaged in the furnishing or sale of water or sewage services if the rates for such furnishing or sale, as the case may be, have been established or approved by

- A State or political subdivision thereof,
- By an agency or instrumentality of the United States,
- By a public service or public utility commission or other similar body of the District of Columbia or of any State or political subdivision thereof, or

[294] IRC §7451(b) as added by the Infrastructure Investment and Jobs Act
[295] IRC §7508A(a)(1) and (b) as revised by the Infrastructure Investment and Jobs Act
[296] IRC §7508A(e) as added by the Infrastructure Investment and Jobs Act
[297] Infrastructure Investment and Jobs Act §80601(b)
[298] IRC §118(c) as added by the Infrastructure Investment and Jobs Act

- By a foreign country or an agency or instrumentality or political subdivision thereof.

Such a corporation is not required to provide water or sewage disposal services to members of the general public in its service area.[299]

A *contribution in aid of construction* will be defined by regulations promulgated by the Treasury Department except that the term shall not include amounts paid as service charges for starting or stopping services.[300]

The Act provides that an excludable contribution to capital includes any amount of money or other property received from any person (whether or not a shareholder) by a regulated public utility which provides water or sewerage disposal services if—

- The amount is —
  - A *contribution in aid of construction*, or
  - A contribution to the capital of such utility by a governmental entity providing for the protection, preservation, or enhancement of drinking water or sewerage disposal services,
- In the case of a contribution in aid of construction which is property other than water or sewerage disposal facilities, such amount meets the requirements of the *expenditure rule*, and
- Such amount (or any property acquired or constructed with such amount) is not included in the taxpayer's rate base for ratemaking purposes.[301]

The *expenditure rule*, noted above for construction of other then water or sewage disposal facilities, is met if —

- An amount equal to such amount is expended for the acquisition or construction of tangible property that qualifies as §1231 property used in a trade or business—
  - Which is the property for which the contribution was made or is of the same type as such property, and
  - Which is used predominantly (80% or more) in the trade or business of furnishing water or sewerage disposal services,
- The expenditure occurs before the end of the second taxable year after the year in which such amount was received, and

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[299] IRC §118(c)(3)(C) as modified by the Infrastructure Investment and Jobs Act, IRC §7701(a)(33)
[300] IRC §118(c)(3)(A) as modified by the Infrastructure Investment and Jobs Act
[301] IRC §118(c)(1) as modified by the Infrastructure Investment and Jobs Act

- Accurate records are kept of
  - The amounts contributed and expenditures made,
  - The expenditures to which contributions are allocated, and
  - The year in which the contributions and expenditures are received and made.[302]

Not unexpectedly since the item is excluded from income, the corporation will not be able to claim certain tax benefits. Specifically:

- No deduction or credit shall be allowed for, or by reason of, any expenditure which constitutes a contribution in aid of construction excluded from income under this rule and
- The adjusted basis of any property acquired with such contributions in aid of construction shall be zero.[303]

Taxpayers will be required in some cases to notify the IRS they are making use of this provision or the statute of limitations on assessing taxes related to this provision will not begin to run until such disclosure is made. The Act provides that if the taxpayer for any taxable year treats an amount as a contribution to the capital of the taxpayer, then—

- The statutory period for the assessment of any deficiency attributable to any part of such amount shall not expire before the expiration of 3 years from the date the IRS is notified by the taxpayer (in such manner as the IRS may prescribe) of—
  - The amount of the expenditure for construction of qualifying tangible §1231 property,
  - The taxpayer's intention not to make the expenditures for such property, or
  - A failure to make such expenditure for the property before the end of the second taxable year after the year in which it received the amount, and
- Such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.[304]

[302] IRC §118(c)(2) and (3)(B) as modified by the Infrastructure Investment and Jobs Act
[303] IRC §118(c)(4) as modified by the Infrastructure Investment and Jobs Act
[304] IRC §118(d) as modified by the Infrastructure Investment and Jobs Act

Extension of Interest Rate Stabilization. (IRC §430, Act §80602)

Effective date.—The amendments made by this section shall apply with respect to plan years beginning after December 31, 2021.[305]

The interest rate stabilization table related to the minimum funding standards for single-employer defined benefit plans found at IRC §430(h)(2)(C)(iv)(II) is changed to extend for an additional five years the amounts for the applicable minimum percentage and applicable maximum percentages that were scheduled to expire at the end of 2025 for another five years.[306] The new table provides:

If the calendar year is:	The applicable minimum percentage is:	The applicable maximum percentage is:
Any year in the period starting in 2012 and ending in 2019	90%	110%
Any year in the period starting in 2020 and ending in 2030	95%	105%
2031	90%	110%
2032	85%	115%
2033	80%	120%
2034	75%	125%
After 2034	70%	130%

The same revisions are made to the same table found at subclause (II) of section 303(h)(2)(C)(iv) of the Employee Retirement Income Security Act of 1974 (ERISA).[307]

Information Reporting for Brokers and Digital Assets. (IRC §§6045 & 6045A, Act §80603)

Effective date.—The amendments made by this section shall apply to returns required to be filed, and statements required to be furnished, after December 31, 2023.

One of the most discussed tax provisions of the IIJA with concerns being raised about the breadth of the transactions and entities that would be covered by these rules on

[305] Infrastructure Investment and Jobs Act §80602(c)
[306] IRC §430(h)(2)(C)(iv)(II) as modified by the Infrastructure Investment and Jobs Act
[307] Infrastructure Investment and Jobs Act §80602(b)

digital assets, including concerns expressed by the Chairman of the Senate Finance Committee as the bill was nearing a Senate vote. Chairman Wyden proposed revised language, but an agreement was not reached before the bill came up for a vote.

As the provision does not take effect until returns filed in 2024 covering 2023, it is very possible these provisions will be subject to changes in future legislation.

For purposes of these rules, a *digital asset* is—

> Except as otherwise provided by the Secretary, the term 'digital asset' means any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary.[308]

For purposes of the information reporting rules related to brokers under IRC §6045, the IIJA adds to the definition of brokers the following class of entities:

> (D) any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person.[309]

The Act also removes the word "other person" from the class that includes any person who "regularly acts as a middleman with respect to property or services."[310] This would allow dealers, barter exchanges and digital asset transfer entities to also qualify under this middleman category.

The Act also adds *digital assets* to the list of specified securities that currently includes stocks, bonds and other evidence of indebtedness, commodities and other financial instruments.[311] These items are subject to the special reporting rules of this section, generally requiring issuance of Forms 1099B regarding their sale and the basis of such item sold.

The *applicable date* for digital assets for these rules (generally the date of acquisition on or after which the basis of the asset must be reported on the Form 1099B when the asset is sold) is January 1, 2023 for any *digital asset*,[312] which is in line with the effective date of these rules. The first reports will be required for calendar year 2023 which are to be filed by February 15, 2024.

[308] IRC §6045(g)(3)(D) as modified by the Infrastructure Investment and Jobs Act
[309] IRC §6045(c)(1)(D) as modified by the Infrastructure Investment and Jobs Act
[310] IRC §6045(c)(1)(C) as modified by the Infrastructure Investment and Jobs Act
[311] IRC §6045(g)(3)(B)(iv) as modified by the Infrastructure Investment and Jobs Act
[312] IRC §6045(g)(3)(C)(iv) as modified by the Infrastructure Investment and Jobs Act

IRC §6045A is modified by the Act to add the following reporting requirements for affected entities handling *digital assets*—

> (d) Return requirement for certain transfers of digital assets not otherwise subject to reporting.—Any broker, with respect to any transfer (which is not part of a sale or exchange executed by such broker) during a calendar year of a covered security which is a digital asset from an account maintained by such broker to an account which is not maintained by, or an address not associated with, a person that such broker knows or has reason to know is also a broker, shall make a return for such calendar year, in such form as determined by the Secretary, showing the information otherwise required to be furnished with respect to transfers subject to subsection (a).[313]

IRC §6045(a) defines transfers subject to its requirements as follows—

> Every applicable person which transfers to a broker (as defined in section 6045(c)(1)) a covered security (as defined in section 6045(g)(3)) in the hands of such applicable person shall furnish to such broker a written statement in such manner and setting forth such information as the Secretary may by regulations prescribe for purposes of enabling such broker to meet the requirements of section 6045(g).[314]

Failure to file the required information returns and provide them to customers will subject the entity to penalties. However, such penalties can be waived for reasonable cause under IRC §6724.[315]

The Act provides that *digital assets* will be treated as cash for purposes of the cash transaction reporting rules of IRC §6050I.[316] The section requires trade or businesses that receive cash transactions in excess of $10,000 to report such transactions to the Treasury, so customers will not be able to avoid reporting by using digital assets to purchase items and keep the transaction from being reported to the U.S. government.

The Act contains a special "rule of construction" that provides:

> (d) Rule of construction.—Nothing in this section or the amendments made by this section shall be construed to create any inference, for any

[313] IRC §6045A(d) as modified by the Infrastructure Investment and Jobs Act
[314] IRC §6045A(a) as modified by the Infrastructure Investment and Jobs Act
[315] IRC §6724(d)(1)(B)(xxvii) as modified by the Infrastructure Investment and Jobs Act
[316] IRC §6050(d)(3) as modified by the Infrastructure Investment and Jobs Act

period prior to the effective date of such amendments, with respect to—

(1) whether any person is a broker under section 6045(c)(1) of the Internal Revenue Code of 1986, or

(2) whether any digital asset is property which is a specified security under section 6045(g)(3)(B) of such Code.[317]

Termination of Employee Retention Credit for Employers Subject to Closure Due to COVID–19. (IRC §3134, Act §80604)

Effective date.—The amendments made by this section shall apply to calendar quarters beginning after September 30, 2021.

The Act denies access to the employee retention tax credit in the fourth quarter of 2021 to employers other than those that qualify as "recovery startup businesses" under IRC §3134(c)(5). Such employers that continue to qualify for the final quarter of 2021 are those that —

- Began carrying on any trade or business after February 15, 2020, and
- For which the average annual gross receipts of such employer (as determined under rules similar to the rules under IRC §448(c)(3)) for the 3-taxable-year period ending with the taxable year which precedes the calendar quarter for which the credit is determined does not exceed $1,000,000.[318]

Such businesses will qualify as recovery startup businesses even if they were subject to a full or partial suspension of their business (as defined by IRC §3134(c)(2)(A)(ii)(I)) or had a decline in gross receipts of greater than 20% in either the 3rd or 4th quarter of 2021 as compared to the same quarter in 2019 (see IRC §3134(c)(2)(A)(ii)(II)).[319]

Originally, if the employer had met at least one of those tests to qualify for the credit, they no longer could claim the credit as a recovery startup business for the quarter. But as those options to qualify for the credit no longer exist for the fourth quarter of 2021, the Act no longer looks to those tests to see if an entity is barred from being a recovery startup business for the fourth quarter of 2021.

Although the Senate passed the Act containing this provision well before the 4th quarter of 2021 began, issues in the House caused that chamber's vote in favor of the Act to be delayed until late in the evening of November 5, 2021, over a month after the 4th quarter began. For now, it is not clear if employers who would have qualified due to the

[317] Infrastructure Investment and Jobs Act §80602(d)
[318] IRC §3134(c)(5) as modified by the Infrastructure Investment and Jobs Act
[319] IRC §3134(c)(5) as modified by the Infrastructure Investment and Jobs Act

drop in gross receipts tests or full/partial suspension test and reduced their payroll tax deposits prior to passage of the Act will face late deposit penalties for the payroll taxes they failed to deposit.

While the law as written would appear to apply those penalties, IRS relief in this area seems very likely, though not assured. Advisers should watch for IRS guidance on this issue to see if any relief is offered and, if so, when the employers who did reduce their payroll tax deposits will be required to pay over the funds that they had not paid over in anticipation of receiving the tax credit for the fourth quarter of 2021.

NOTES

Unit

6

Individual Developments

LEARNING OBJECTIVES

When you have completed this unit, you will be able to

- **Understand** the impact of the IRS approval of passthrough entity tax SALT workarounds on individual tax clients with interests in partnerships and S corporations
- **Obtain** a general understanding of key individual tax developments over the past year and apply them to specific taxpayer situations

SECTION: 108
IRS NOTES NONACQUIESENCE WITH COURT HOLDING AN INTEREST IN A DEFINED BENEFIT PENSION PLAN WAS NOT AN ASSET FOR INSOLVENCY TEST

Citation: Action on Decision AOD 2021-01, 4/9/21

In Action on Decision AOD 2021-01 the IRS announced that the agency will not acquiesce in a decision that treated an interest in a defined benefit pension plan in which the taxpayer only had rights to monthly payment was not an asset for computation of the insolvency exception to the exclusion of cancellation of debt income from tax under IRC §108(a)(2).

The case in question is the case of *Schieber v. Commissioner*, TC Memo 2017-32. As the court opinion noted:

> The sole issue in this case is whether the Schiebers' interest in a California Public Employees' Retirement System (CalPERS) defined

> benefit pension plan is considered an asset in determining (1) whether they were insolvent on June 30, 2009, the date the debt was canceled, and (2) the amount of their insolvency.[320]

The Tax Court held that this asset should not be counted in determining if the taxpayer was solvent at the time the debt was cancelled:

> [T]he IRS contends the Schiebers' interest in the pension plan should be considered an asset because they can use their monthly payments to pay liabilities. But the test in *Carlson v. Commissioner*, 116 T.C. at 104-105, is whether the asset gives the taxpayer the ability to pay an "immediate tax on income" from the canceled debt—not to pay the tax gradually over time. In Carlson, we held that a commercial fishing license could be an asset because the license could be used, in combination with other assets, to immediately pay the income tax on canceled-debt income. *Id.* By contrast, the Schiebers' interest in the pension plan cannot be used to immediately pay the income tax on canceled-debt income. Therefore, we hold that the Schiebers' interest in the pension plan is not an asset within the meaning of section 108(d)(3).[321]

In a footnote, the Tax Court considered and rejected the IRS argument that the Court's prior decision in the *Shepherd* case supported including this asset in computing the taxpayer's solvency.

> The IRS contends that *Shepherd v. Commissioner*, T.C. Memo. 2012-212, a nonprecedential case, supports its view that the Schiebers' interest in the CalPERS pension plan is an asset. The taxpayer in Shepherd was a township employee who had a pension with the New Jersey Public Employees Retirement System. Id., slip op. at 12. The Court found that he could borrow from his pension against his

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[320] *Schieber v. Commissioner*, TC Memo 2017-32, February 9, 2017, https://app.dawson.ustaxcourt.gov/documents/2ceba57c-165d-4af0-8198-c52f02178f88?AWSAccessKeyId=ASIA6IROMRYRLJ6W7IVS&Expires=1618058051&Signature=oNeAp4eicPsFxqWHBp0c63IPHgw%3D&x-amz-security-token=IQoJb3JpZ2luX2VjEDQaCXVzLXdlc3QtMSJGMEQCIBzcYflhwQqnYuvoernHX290g8fgyQLO8JarEpb3aP3WAiA%2BzH66ZolG8iQ9moyy%2FpfwlSk7Ck3gRfV2jSRehuDnvSrcAQiN%2F%2F%2F%2F%2F%2F%2F%2F%2F%2F%2F8BEAAaDDk4MDQyMzU3NzEyMiIMvySLpI7lE7wfhe55KrAB5WhfiSCSEYNIHeD8766EJPnUd4MZDllBau7P8NYe%2B5jJdKahRyRwsJGUUMv4XyHdqKc0f8%2BhjBQo5Dgl7scc%2FvWrON1O7sODuwjXK3rGTzS0SPcqhXH%2FixJfSBn8lomJGHrGbx%2FkLabyrLwjdnNP3NXm0A%2F2CseiPNfgXKuEwWfDdQ6KwkBNJP3wfDKUb2VltNUf%2Bxd7vvevqQ%2BT%2BR5VpxuoLndBC3eCjncj4iPIsWYwk5bGgwY64QFvHBrd5yH9vxtBO29r1h4qc0aAiZLFmOVUDEDD6I1MK3dD9DAS%2BIb9Zc5C5tZDlJXH4qY%2BRAMlMuiv1ihrcTEd4KuhajMravGYI51URg%2Bh4xZ5wF69QIPUe4FbfwebN6Eakk5dfNFRrSmLB4NrFQlUJtYOS%2FphMMgCNbWME%2BLwWe3PvrS%2Fz21yKjEg26iR2u5X5JezJmrdhjRzsSqJnVBbA5rMDRlzCfHVQ5hGKluG81SHS7nBDgqkr%2Fk5TG1ObpX3IC7C9rY%2FWRDdeKveHgN%2F3nM7aWOR%2Bzh5RGw1Y9QwqSY%3D (retrieved April 10, 2021)

[321] *Schieber v. Commissioner*, TC Memo 2017-32, February 9, 2017

> accumulated contributions. Eat 13-14. It held that the amount that he could borrow was an asset under sec. 108(d)(3). Eat 14. The Schiebers, by contrast, could not borrow from the pension. Shepherd is therefore distinguishable.[322]

The IRS has now decided to go on the record with its disagreement with this decision by noting its nonacquiescence. The AOD describes the impact of such a holding as follows:

> "Nonacquiescence" signifies that, although no further review was sought, the Service does not agree with the holding — of the court and, generally, will not follow the decision in disposing of cases involving other taxpayers. In reference to an opinion of a circuit court of appeals, a "nonacquiescence" indicates that the Service — will not follow the holding on a nationwide-basis. However, the Service will recognize the precedential impact of the opinion on cases arising within the venue of the deciding circuit.[323]

Thus, the IRS is putting taxpayers and advisers on notice that the agency will be willing to challenge a position that relies on this case where a taxpayer has only a right to a current monthly payout from the retirement plan, but no current right to otherwise access funds in the plan.

Specifically, the AOD holds:

> The Commissioner does NOT ACQUIESCE in the following decision:
>
> *Schieber v. Commissioner*, T.C. Memo. 2017-32, T.C. Docket No. 21690-14.[324]

In a footnote the IRS provides the specific holding it will not follow:

> Nonacquiescence to the holding that an interest in a defined benefit pension plan is not an asset for purposes of applying the insolvency exclusion in I.R.C. § 108.

[322] *Schieber v. Commissioner*, TC Memo 2017-32, February 9, 2017
[323] Action on Decision AOD 2021-01, April 9, 2021
[324] Action on Decision AOD 2021-01, April 9, 2021

SECTION: 162
TAXPAYER FAILS IN ATTEMPT TO USE THE COHAN RULE TO OBTAIN A DEDUCTION

Citation: Fagenboym *v.* Commissioner, TC Summ. Op. 2021-19, 7/19/21

In the case of *Fagenboym v. Commissioner* [325] we see a taxpayer unsuccessfully attempt to make use of the most-cited case in federal income tax cases—the case of *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930).

For those who aren't familiar with the *Cohan* case, the case involved vaudeville producer and entertainer George M. Cohan and produced what is often referred to as the *Cohan* doctrine or rule. The opinion summarizes this rule as follows:

> Under the *Cohan* rule, when a taxpayer establishes that he or she has incurred a deductible expense, but is unable to substantiate the exact amount, the Court is permitted to estimate the deductible amount. *Id*. at 543-544. But we can do so only to estimate the amount of the deductible expense when the taxpayer provides evidence sufficient to establish a rational basis upon which the estimate can be made. See *Vanicek v. Commissioner*, 85 T.C. 731, 743 (1985). In estimating the amount allowable the Court bears heavily upon the taxpayer who failed to maintain required records and to substantiate expenses as the Code requires. See *Cohan v. Commissioner*, 39 F.2d at 544; *Keenan v. Commissioner*, T.C. Memo. 2006-45, *aff'd*, 233 F. App'x 719 (9th Cir. 2007).[326]

Essentially, a taxpayer looks to use the *Cohan* rule when the taxpayer has deficient or non-existent records to support a deduction, a problem which George M. Cohan successfully was able to overcome in his 1930 case.

However, this also means the taxpayer is generally working from a position of weakness. Two major hurdles face a taxpayer looking to use this rule which the Court pointed out.

- The taxpayer has to show a rational basis upon which the Court can make an estimate and
- The Court "bears heavily" against the taxpayer based on his/her amount of culpability that led to the lack of records.

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[325] *Fagenboym v. Commissioner,* TC Summ. Op. 2021-19, July 19, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/couple-swerved-too-far-from-substantiation-rules%2c-tax-court-says/76wnf (retrieved July 19, 2021)
[326] *Fagenboym v. Commissioner,* TC Summ. Op. 2021-19, July 19, 2021

In reality, the second factor has an impact on the first—the more responsible the taxpayer was for the lack of records, the less likely it generally is that the Court will find that the taxpayer had provided a rational basis upon which to estimate the expenses in question.

In this case, Mr. Fagenboym was a shareholder in an S corporation (Alcor Electric) that could not document certain amounts paid for purchases from one of the corporation's suppliers. The taxpayer offered the following information upon which he asked the Court to grant an allowance for purchases related to the supplier.

> Mr. Fagenboym submitted four pages of handwritten calculations that attempt to reconstruct Alcor Electric's purchases and other expenses related to four alleged business contracts. Mr. Fagenboym testified that he created the handwritten document because he was unable to produce original records of the amounts paid to one of Alcor Electric's electrical suppliers, Alameda Electrical Distributors (AED), on the four business contracts. In support of his calculations Mr. Fagenboym testified that he was able to estimate the amount paid to AED by Alcor Electric during the year in issue by taking the total amount paid to the S corporation on each of the four contracts and subtracting a 12% profit margin to produce an estimated total for the hard costs of each project. Mr. Fagenboym then subtracted all known labor and materials costs from the resulting total hard costs to produce the estimated total paid to AED on each contract. During the trial Mr. Fagenboym did not produce contemporaneous records or any other business records pertaining to Alcor Electric's operations. He testified that he had previously provided substantiating documents to respondent for all hard costs on the four contracts except for the amounts paid to AED.[327]

However, the Tax Court found that this fell short of what was necessary to provide the Court with a rational basis upon which to calculate a deduction:

> Although Mr. Fagenboym's testimony about industry operations was generally reliable, the amounts included in the handwritten calculations proffered are not backed by any underlying bank statements, receipts, or other documentation. Mr. Fagenboym testified that the 12% profit margin on which his calculations hinge was a rough estimate based on similar contracts in the industry. He stated that the 12% figure was "potential profit" but noted that Alcor Electric's actual profit was "much less than that".
>
> Although we have no doubt that Mr. Fagenboym produced his calculations in good faith, the reconstruction of expenses on the basis of an individual's estimate of industry standard profit margins does not

[327] *Fagenboym v. Commissioner,* TC Summ. Op. 2021-19, July 19, 2021

> take the place of substantiation or provide a rational basis upon which an estimate can be made under the Cohan rule. The record includes no reliable evidence establishing error in respondent's determinations in the notice disallowing petitioners' claimed loss deductions related to certain expenses reported by Alcor Electric during the year in issue. On the record before us, we conclude that petitioners have failed to carry their burden of establishing that Alcor Electric paid or incurred the expenses underlying the deductions that respondent disallowed for its 2015 tax year. We therefore sustain respondent's determination in the notice of deficiency disallowing a portion of petitioners' claimed Schedule E loss deductions for the year in issue.[328]

What makes this case somewhat unusual is that while the judge found the taxpayer's testimony credible and even appears to have some sympathy for the taxpayer, he still found the methodology too flawed to be used to estimate the deduction in question.

SECTION: 164
PASSTHROUGH TAXES CREATED BY STATES AS SALT WORKAROUNDS WILL BE ALLOWED AS DEDUCTION WITHOUT REGARD TO ANY SALT LIMITATIONS

Citation: Notice 2020-75, 11/9/20

The IRS has now released guidance that proposed regulations will be released that will allow partnerships and S corporations to deduct state and local income taxes imposed on the entity.[329] This development resolves an issue that has been around since Connecticut enacted the first passthrough tax following the passage of the Tax Cuts and Jobs Act.

[328] *Fagenboym v. Commissioner,* TC Summ. Op. 2021-19, July 19, 2021

[329] Notice 2020-75, November 9, 2020, https://www.irs.gov/pub/irs-drop/n-20-75.pdf (retrieved November 9, 2020)

The IRS notes the following:

> Certain jurisdictions described in section 164(b)(2) have enacted, or are contemplating the enactment of, tax laws that impose either a mandatory or elective entity-level income tax on partnerships and S corporations that do business in the jurisdiction or have income derived from or connected with sources within the jurisdiction. In certain instances, the jurisdiction's tax law provides a corresponding or offsetting, owner-level tax benefit, such as a full or partial credit, deduction, or exclusion. The Treasury Department and the IRS are aware that there is uncertainty as to whether entity-level payments made under these laws to jurisdictions described in section 164(b)(2) other than U.S. territories must be taken into account in applying the SALT deduction limitation at the owner level.[330]

The IRS begins by announcing that they will be issuing proposed regulations to allow this deduction:

> (1) Purpose and scope. The Treasury Department and the IRS intend to issue proposed regulations to provide certainty to individual owners of partnerships and S corporations in calculating their SALT deduction limitations. Based on the statutory and administrative authorities described in section 2 of this notice, the forthcoming proposed regulations will clarify that Specified Income Tax Payments (as defined in section 3.02(1) of this notice) are deductible by partnerships and S corporations in computing their non-separately stated income or loss.[331]

The Notice provides the following with regard to the deduction of such payments:

> (2) Deductibility of Specified Income Tax Payments. If a partnership or an S corporation makes a Specified Income Tax Payment during a taxable year, the partnership or S corporation is allowed a deduction for the Specified Income Tax Payment in computing its taxable income for the taxable year in which the payment is made.[332]

The term *Specified Income Tax Payment* is defined as follows:

> For purposes of section 3.02 of this notice, the term "Specified Income Tax Payment" means any amount paid by a partnership or an S corporation to a State, a political subdivision of a State, or the District of Columbia (Domestic Jurisdiction) to satisfy its liability for income taxes imposed by the Domestic Jurisdiction on the partnership or the S

[330] Notice 2020-75, Section 2.02(3)
[331] Notice 2020-75, Section 3.01
[332] Notice 2020-75, Section 3.02(2)

> corporation. This definition does not include income taxes imposed by U.S. territories or their political subdivisions.[333]

One area of concern that some had with regard to the entity level passthrough taxes imposed by states was that some were imposed at the election of the entity. Would the fact that an entity has elected to pay the tax eliminate the treatment as a tax imposed on the entity? The IRS has decided that is not an issue. Similarly, the fact that a partner ends up with a benefit against his/her tax liability also is not a problem for such taxes.

> For this purpose, a Specified Income Tax Payment includes any amount paid by a partnership or an S corporation to a Domestic Jurisdiction pursuant to a direct imposition of income tax by the Domestic Jurisdiction on the partnership or S corporation, without regard to whether the imposition of and liability for the income tax is the result of an election by the entity or whether the partners or shareholders receive a partial or full deduction, exclusion, credit, or other tax benefit that is based on their share of the amount paid by the partnership or S corporation to satisfy its income tax liability under the Domestic Jurisdiction's tax law and which reduces the partners' or shareholders' own individual income tax liabilities under the Domestic Jurisdiction's tax law.[334]

The tax will *not* be a separately stated item, but rather will be part of the non-separately stated income or loss from the partnership or S corporation:

> Any Specified Income Tax Payment made by a partnership or an S corporation during a taxable year does not constitute an item of deduction that a partner or an S corporation shareholder takes into account separately under section 702 or section 1366 in determining the partner's or S corporation shareholder's own Federal income tax liability for the taxable year. Instead, Specified Income Tax Payments will be reflected in a partner's or an S corporation shareholder's distributive or pro-rata share of nonseparately stated income or loss reported on a Schedule K-1 (or similar form).[335]

As well, the amounts paid will not be taken into account for the individual SALT limitation:

> Any Specified Income Tax Payment made by a partnership or an S corporation is not taken into account in applying the SALT deduction limitation to any individual who is a partner in the partnership or a shareholder of the S corporation.[336]

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[333] Notice 2020-75, Section 3.02(1)
[334] Notice 2020-75, Section 3.02(1)
[335] Notice 2020-75, Section 3.02(3)
[336] Notice 2020-75, Section 3.02(4)

The applicability date allows taxpayers to deduct taxes paid on such taxes generally for years ending after December 31, 2017:

> The proposed regulations described in this notice will apply to Specified Income Tax Payments made on or after November 9, 2020. The proposed regulations will also permit taxpayers described in section 3.02 of this notice to apply the rules described in this notice to Specified Income Tax Payments made in a taxable year of the partnership or S corporation ending after December 31, 2017, and made before November 9, 2020, provided that the Specified Income Tax Payment is made to satisfy the liability for income tax imposed on the partnership or S corporation pursuant to a law enacted prior to November 9, 2020. Prior to the issuance of the proposed regulations, taxpayers may rely on the provisions of this notice with respect to Specified Income Tax Payments as described in this section 4.[337]

SECTION: 164
IRS LETTER TO CONGRESSIONAL OFFICE INDICATES THAT $10,000 CAP APPLIES TO DEDUCTION OF REAL ESTATE TAXES ON REAL ESTATE COOPERATIVE UNIT UNDER §216

Citation: Information Letter 2020-0010, 9/25/20

In an information letter,[338] the IRS has informally addressed an issue that has existed since the passage of the Tax Cuts and Jobs Act—does the $10,000 state and local tax deduction cap apply to the special deduction under IRC §216 to a shareholder's portion of taxes paid by a housing cooperative?

In February 2019[339] we published an article looking at the interaction of the limitation on personal state and local taxes found at IRC §164(b)(6) and the deduction allowed for owners of shares in a real estate cooperative under IRC §216. A real estate cooperative is an alternative to the use of a condominium structure to have an individual purchase a segment (or unit) in a particular building. The cooperative is a corporation that owns the building, with each shareholder normally having the right to occupy a particular unit.

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[337] Notice 2020-75, Section 4

[338] Information Letter 2020-0010, September 25, 2020, https://www.irs.gov/pub/irs-wd/20-0010.pdf (retrieved October 28, 2020)

[339] Edward Zollars, "Owners of Shares in Housing Cooperatives May Escape $10,000 Limit on Tax Deduction Due to Drafting Error in TCJA," *Current Federal Tax Developments* website, February 22, 2020, https://www.currentfederaltaxdevelopments.com/blog/2019/2/22/owners-of-shares-in-housing-cooperatives-may-escape-10000-limit-on-tax-deduction-due-to-drafting-error-in-tcja (retrieved October 28, 2020)

Since the property tax would be imposed on the corporation as owner of the building rather than the shareholder, IRC §216 provides a method for the shareholder to claim his/her share of the taxes paid by the corporation.

As was described in the article, it appeared the language of the Tax Cuts and Jobs Act added at §164(b)(6) to limit itemized deductions for state and local taxes other than for business or investment properties failed to specifically limit taxes for which the deduction was allowed under IRC §216. As was noted, the Blue Book indicated that it was Congress's intent to have the limit applied, but the Blue Book text also contained the footnote reference that a technical correction might be necessary to achieve that result—that is, the text of the law might not be drafted properly to achieve the intended result.

Congressman Jerrold Nadler's office made an inquiry to the IRS about whether, in fact, this limitation applied and, in a letter dated July 29, 2020, but formally released on the IRS website later, the IRS addressed the issue.

The IRS letter takes the position that the limitation does apply to these taxes under IRC §216:

> The SALT limitation under section 164(b)(6) applies to the deduction taken into account by a tenant-stockholder under section 216 for the tenant-stockholder's proportionate share of the real estate taxes paid or incurred by a cooperative housing corporation.[340]

The letter provides the following analysis in support of this position:

> Section 164 generally allows an itemized deduction for certain taxes, including state and local real property tax, state and local personal property tax, and state and local income tax or state and local sales tax, for the taxable year in which paid Section 164(b)(6), which was added by the Tax Cut and Jobs Act of 2017, limits an individual's deduction for the taxable year to an aggregate amount of the state and local taxes taken into account during the taxable year to $10,000 (or $5,000 in the case of a married individual filing a separate return) for taxable years beginning after December 31, 2017, and before January 1, 2026.
>
> Section 216(a) allows a deduction by a tenant-stockholder for the tenant-stockholder's proportionate share of the real estate taxes allowable as a deduction to the cooperative housing corporation under section 164. The legislative history to section 216 states that "[t]he general purpose of this provision is to place the tenant stockholders of a cooperative apartment in the same position as the owner of a dwelling house so far as deductions for interest and taxes is concerned." S. Rep. No. 1621, 77th Cong., 2d Sess. 51 (1942).

[340] Information Letter 2020-0010, p.2

> Further, regarding the SALT limitation, the Joint Committee on Taxation states that "[i]t is intended that the limitation apply to the deduction for amounts paid or accrued to a cooperative housing corporation by a tenant-stockholder under section 216(a)(1) (relating to real estate taxes) in the same manner as the limitation applies to real estate taxes under section 164." Joint Committee on Taxation Staff, *General Explanation of Public Law 115-97*, JCS-1-18 p. 68 (December 2018).[341]

The analysis is interesting in that it relies entirely on statements of Congressional intent and steers clear of analyzing the actual text of the section in question. As well, while quoting the Blue Book (the *General Explanation of Public Law 115-97*), the letter avoids mentioning the footnote that was tied to the passage quoted that indicates a law change might be necessary to achieve this result.

So where does this leave taxpayers and advisers? First, advisers should include the fact that, as informal as these letters are, the IRS is on record as deciding the limit applies when advising taxpayers on the matter. Even if the IRS position is improper, there would be costs incurred to defend the position if it is challenged on exam, costs that would be avoided if the taxpayer simply applied the cap. That is, the full deduction might be justified, but the costs of carrying the issue could be greater ultimately than the taxes saved.

But, as well, it's important to note that the IRS is issuing this guidance in a format that carries little or no authority beyond the persuasive nature of the legal analysis—and analysis that, conveniently, ignores the language found in the relevant provisions. Generally, Congressional intent only matters when attempting to resolve ambiguity in the law—but the IRS does not attempt to first show the existence of such ambiguity in the positions in question. If the law itself can only reasonably be read to lead to one result, that is the result that matters regardless of intent.

And, frankly, the IRS has applied that very standard to other TCJA provisions. Although clearly Congress intended for qualified improvement property to have a 15-year life and be eligible for bonus depreciation treatment when the TCJA was passed, the IRS took the position that the law itself did not support that treatment. Eventually, Congress passed a technical correction in the CARES Act to modify the law to agree with the intent.

At this point, it would appear that taking the position that a deduction in full is allowed under §216 is at the very least a reasonable interpretation of the law. For that reason, an adviser should be able to sign a return taking that position if the taxpayer wishes to risk an IRS challenge. The adviser may decide the position lacks substantial authority, or that it might be viewed as doing so, and decide that disclosure of the position on a Form 8275 may be appropriate.

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341 Information Letter 2020-0010, pp. 1-2

But, fundamentally, aside from the IRS going on the record in a rather obscure manner indicating the limit should apply, nothing much has changed regarding this issue. Only time will tell if this is merely IRS saber-rattling to scare taxpayers away from doing this (and thus, actual challenges would be rare) or if the agency seriously plans to pursue these positions. And, in the latter case, it will likely take a few more years before any such case ends up before the courts for a ruling on the matter.

SECTION: 172
IRS PROVIDES PROCEDURES FOR MAKING ELECTIONS PROVIDED UNDER CTRA 2020 FOR FARM NET OPERATING LOSSES

Citation: Revenue Procedure 2021-14, 6/30/21

Guidance has been issued to farmers for elections related to net operating losses added by the COVID-related Tax Relief Act of 2020 (CTRA) in Revenue Procedure 2021-14.[342] The Procedure broadly described its guidance as follows:

> Specifically, this revenue procedure prescribes when and how to make an election with regard to all NOLs of the taxpayer, regardless of whether the NOL is a Farming Loss NOL. This revenue procedure also provides that a taxpayer is treated as having made a deemed election under § 2303(e)(1) of the CARES Act if the taxpayer, before December 27, 2020, filed one or more original or amended Federal income tax returns, or applications for tentative refund, that disregard the CARES Act Amendments with regard to a Farming Loss NOL. This revenue procedure further prescribes when and how to revoke an election made under § 172(b)(1)(B)(iv) or § 172(b)(3) of the Code to waive the two-year carryback period for the farming loss portion of a Farming Loss NOL incurred in a taxable year beginning in 2018 or 2019.[343]

CTRA sought to grant relief to farmers that Congress had impacted by changes meant to grant a tax benefit in the CARES Act. Under TCJA, beginning in 2018 net operating losses could no longer be carried back generally and only could offset 80% of taxable income. However, TCJA did allow a farm loss to be carried back two years.

The CARES Act suspended the TCJA changes until 2021 and provided for a five-year net operating loss carryback unless a taxpayer elected to carry the loss forward for 2018-2020. However, in doing so Congress, likely without really realizing it, required farmers to choose between carrying their losses back five years *or* carrying the loss

[342] Revenue Procedure 2021-14, June 30, 2021, https://www.irs.gov/pub/irs-drop/rp-21-14.pdf (retrieved June 30, 2021)
[343] Revenue Procedure 2021-14, Section 1.02

forward. The option to carry the loss back two years was part of the provisions suspended until 2021.

In some cases a farmer found that the five year carryback resulted in a lower refund than if the loss went back two years. As well, most 2018 loss carrybacks (and even some 2019 ones) had already been filed by farmers by the time the CARES Act was passed in March of 2020—meaning those farmers now had to revise those carrybacks to either carry the loss back five years *or* elect to carry the loss forward. The farmer did not have the option to simply accept the already filed two-year carryback.

CTRA added a provision to allow farmers various options with these losses.

Election to Ignore CARES Act Changes

Section 2303(e)(1) of the CARES Act, as revised by CTRA 2020, allows a farmer to make an election for tax years beginning in 2018, 2019, or 2020 to disregard the CARES Act changes to NOLs found at CARES Act Section 2303(a) and (b) (the five-year carryback).

If such an election is made, the following consequences will follow:

- Application of 80-percent limitation. The 80-percent limitation will apply to determine the NOL deduction for each taxable year beginning in 2018, 2019, or 2020 to the extent the deduction is attributable to NOLs arising in taxable years beginning after December 31, 2017. The 80-percent limitation will not apply to determine the NOL deduction for any taxable year beginning before 2018.[344]

- Application of modified taxable income rules. Section 172(b)(2)(C) of the Code, as added by the TCJA and effective prior to enactment of the CARES Act, provides a modified taxable income rule to account for the 80-percent limitation. This rule will apply with regard to each taxable year beginning in 2018, 2019, or 2020.[345]

- NOL carryback period. The NOL carryback period will be determined under § 172(b) of the Code, as amended by the TCJA and effective prior to enactment of the CARES Act, for any NOL arising in any taxable year beginning in 2018, 2019, or 2020. For example, if a taxpayer with a Farming Loss NOL in 2018 makes the election under § 2303(e)(1), only the portion of the Farming Loss NOL that consists of a farming loss can be carried back two taxable years. In addition, for taxpayers other than insurance companies, as defined in section 816(a) of the Code, that are not life insurance companies, no portion of any NOL that does not constitute a farming loss can be carried back to any taxable year beginning before January 1, 2018.[346]

[344] Revenue Procedure 2021-14, Section 2.03(2)(a)
[345] Revenue Procedure 2021-14, Section 2.03(2)(b)
[346] Revenue Procedure 2021-14, Section 2.03(2)(c)

Making the Election to Ignore the CARES Act Changes

The election described above must meet the following criteria outlined in Section 2303(e) of the CARES Act as revised by CTRA 2020:

> Section 2303(e)(1)(B)(i) of the CARES Act provides that, except in the case of a deemed election described in 3.02(3)(b) of this revenue procedure, an election to disregard the CARES Act amendments (Affirmative Election) under § 2303(e)(1) must be made in the manner prescribed by the Secretary. Once made, an election under § 2303(e)(1) is irrevocable. Section 2303(e)(1)(B)(ii)(I) of the CARES Act generally provides that an Affirmative Election must be made by the due date, including extensions of time, for filing the taxpayer's Federal income tax return for the taxpayer's first taxable year ending after December 27, 2020.[347]

The Revenue Procedure offers up both a deemed election and an affirmative election.

Deemed Election

The simplest option for returns filed before December 27, 2020 that disregarded the CARES Act revisions is to use the deemed election, which requires doing nothing additional. The Procedure provides:

> In the case of any taxpayer with a Farming Loss NOL that files a Federal income tax return before December 27, 2020, that disregards the CARES Act Amendments, the taxpayer is treated as having made a deemed election (Deemed Election) under § 2303(e)(1) unless the taxpayer amends such return to reflect such amendments by the due date (including extensions of time) for filing the taxpayer's Federal income tax return for the first taxable year ending after December 27, 2020.[348]

Affirmative Election

Other than taxpayers making the deemed election just described, a taxpayer with a Farming Loss NOL may make an affirmative election to disregard the provisions related to NOLs under the original CARES Act if

- The Farming Loss NOL arose in any taxable year of the taxpayer beginning in 2018, 2019, or 2020; and

- The taxpayer satisfies all of the following conditions:

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[347] Revenue Procedure 2021-14, Section 2.03(3)(a)

[348] Revenue Procedure 2021-14, Section 2.03(3)(b)

- The taxpayer must make the Affirmative Election on a statement described next by the due date, including extensions of time, for filing the taxpayer's Federal income tax return for the taxpayer's first taxable year ending after December 27, 2020.

- The taxpayer must attach a statement to the taxpayer's Federal income tax return for the taxpayer's first taxable year ending after December 27, 2020. The statement must provide in type or legible writing at the top of the statement the following:

> The taxpayer elects under § 2303(e)(1) of the CARES Act and Revenue Procedure 2021-14 to disregard the amendments made by § 2303(a) of the CARES Act for taxable years beginning in 2018, 2019, and 2020, and the amendments made by § 2303(b) of the CARES Act that would otherwise apply to any net operating loss arising in any taxable year beginning in 2018, 2019, or 2020. The taxpayer incurred a Farming Loss NOL, as defined in section 1.01 of Revenue Procedure 2021- 14, in [list each applicable taxable year beginning in 2018, 2019, or 2020].

The taxpayer should also attach a copy of the statement to any original or amended Federal income tax return or application for tentative refund on which the taxpayer claims a deduction attributable to a two-year NOL carryback pursuant to the Affirmative Election.[349]

Revoking an Election to Waive the Two-Year Carryback Period

The law allows a taxpayer to revoke an election made to waive the two-year carryback period under the following conditions:

> Section 2303(e)(2) of the CARES Act provides taxpayers with the ability to revoke an election made under § 172(b)(1)(B)(iv) or § 172(b)(3) of the Code to waive the two-year carryback period if the election—
>
> (i) was made by the taxpayer before December 27, 2020; and
>
> (ii) relates to the two-year carryback period for the portion of any Farming Loss NOL that is a farming loss arising in taxable years beginning in 2018 or 2019.[350]

[349] Revenue Procedure 2021-14, Section 3.01(2)
[350] Revenue Procedure 2021-14, Section 2.03(4)

Special Rules for Taxpayers With Pre-December 27, 2020 Two Year Carrybacks That Were Rejected

The Procedure notes that certain taxpayers who filed for a two-year carryback prior to December 27, 2020 may have had those claims rejected by the IRS. The Procedure provides:

> If such a taxpayer wants to continue to pursue those claims, the taxpayer should submit complete copies of their rejected applications or claims, including the original or amended Federal income tax returns for the taxable years in which the NOLs arose, in the manner set forth in this section 3.02(2), which will enable the IRS to review their cases as expeditiously as possible.
>
> (a) The taxpayer should submit a complete copy of each rejected application for tentative refund or claim for refund based on a two-year carryback period, including the original or amended Federal income tax return for the taxable year in which the NOL arose, to the IRS Service Center at which the taxpayer previously filed the application or claim and return.
>
> (b) The taxpayer should provide in type or legible writing at the top of the first page of a complete copy of each application or claim the following: "Deemed Election under section 3.02(2) of Revenue Procedure 2021-14."
>
> (c) The complete copy of each application or claim and return should be submitted on or before the due date, including extensions of time, for filing the taxpayer's Federal income tax return for the taxpayer's first taxable year ending after December 27, 2020.[351]

Exception to a Deemed Election

Since obtaining a deemed election simply requires doing nothing by a qualified taxpayer, the Procedure provides a method for such qualified taxpayers to escape deemed election treatment. The Procedure provides:

> A taxpayer will not be treated as having made a Deemed Election if, for each taxable year for which the taxpayer filed an original or amended Federal income tax return or an application for tentative refund that treated a Farming Loss NOL in a manner that disregards the CARES Act Amendments, the taxpayer subsequently files either an amended return by the due date, including extensions of time, for filing the taxpayer's Federal income tax return for the taxpayer's first

[351] Revenue Procedure 2021-14, Section 3.02(2)

> taxable year ending after December 27, 2020, or an application for tentative refund within the required time for filing such an application and also by the due date, including extensions of time, for filing the taxpayer's Federal income tax return for the taxpayer's first taxable year ending after December 27, 2020, that properly reflects the treatment of each Farming Loss NOL under the CARES Act Amendments.[352]

The Procedure provides the following examples of applying this provision:

EXAMPLE, SECTION 3.02(3), REVENUE PROCEDURE 2021-14

A taxpayer who disregarded the CARES Act Amendments by using a 2-year carryback for the farming loss portion of the taxpayer's only Farming Loss NOL and filed Forms 1120X for the two carryback years, and who subsequently timely files a Form 1139 with a 5-year carryback that accounts for that Farming Loss NOL in a manner consistent with the CARES Act Amendments for each of the five carryback years, will not be treated as having made a Deemed Election.

Similarly, a taxpayer who filed a Form 1139 prior to December 27, 2020, and disregarded the CARES Act Amendments by using a 2-year carryback for the farming loss portion of the taxpayer's only Farming Loss NOL and subsequently timely files a Form 1139 with a 5-year carryback that accounts for that Farming Loss NOL in a manner consistent with the CARES Act for each of the five carryback years, will not be treated as having made a Deemed Election.

Waivers of Carryback Periods

Some taxpayers may now wish to revoke their original election to not apply the two-year carryback period for farm losses. The Procedure allows for that as well.

A taxpayer that elected not to have the two-year carryback period apply to the farming loss portion of a Farming Loss NOL incurred in a taxable year beginning in 2018 or 2019 may revoke that election if the taxpayer—

- Made that election before December 27, 2020; and
- Satisfies all of the following conditions:
  - Revocation deadline. A taxpayer must make the revocation under this provision by the date that is 3 years after the due date, including extensions of time, for filing the return for the taxable year the Farming Loss NOL was incurred and
  - Required statement. The taxpayer must attach a statement to an amended return for the loss year. The statement must provide in type or legible writing at the top of the statement the following:

[352] Revenue Procedure 2021-14, Section 3.02(3)

> Pursuant to section 4.01 of Rev. Proc. 2021-14 the taxpayer is revoking a prior §172(b)(1)(B)(iv) or § 172(b)(3) election not to have the two-year carryback period provided by § 172(b)(1)(B)(i) apply to the Farming Loss NOL, as defined in section 1.01 of Rev. Proc. 2021-14, incurred in the taxable year.[353]

Consolidated Groups

The procedure also gives guidance for consolidated groups regarding these elections.

Manner of Making Elections for Consolidated Groups

The Procedure outlines the following manner for making an election for a consolidated group:

> An Affirmative Election under section 3.01 of this revenue procedure and a revocation described in section 4.01 of this revenue procedure are made by the agent for the consolidated group. An amended return described in section 3.02(3) of this revenue procedure is filed, and a Deemed Election under section 3.02 of this revenue procedure is deemed made, by the agent for the consolidated group. See § 1.1502-77(a) and (c).[354]

Consequences of Affirmative and Deemed Elections for a Consolidated Group

The Procedure describes the consequences of the various elections for a consolidated group:

> If the agent for the consolidated group makes an Affirmative Election or a Deemed Election, the consequences described in section 2.03(2) of this revenue procedure apply to the consolidated group. Therefore, for example, if a consolidated group has a CNOL a portion of which is a farming loss, and if the agent for the consolidated group makes an Affirmative Election or a Deemed Election, then the portion of the CNOL that is a farming loss can be carried back two taxable years, and the 80-percent limitation will apply to determine the deduction for the entire CNOL for each taxable year beginning in 2018, 2019, or 2020.[355]

[353] Revenue Procedure 2021-14, Section 4.01

[354] Revenue Procedure 2021-14, Section 5.01(2)

[355] Revenue Procedure 2021-14, Section 5.02

The Procedure also provides:

> Reliance on rules in § 1.1502-21 regarding application of the 80-percent limitation. If a consolidated group makes an Affirmative Election or a Deemed Election, the consolidated group may choose to apply § 1.1502-21(a), (b)(1), (b)(2)(iv), and (c)(1)(i)(E), as revised by TD 9927 (85 FR 67966, Oct. 27, 2020), for its taxable years beginning in 2018, 2019, or 2020.[356]

SECTION: 401
FINAL REGULATIONS MODIFY TABLES FOR COMPUTING RMDS, EFFECTIVE BEGINNING IN 2022

Citation: TD 9930, 11/5/20

The various tables used to compute required minimum distributions from retirement plans have been updated, taking effect beginning in 2022, as the IRS has issued revised regulations under IRC §401(a)(9).[357]

In August 2018, Executive Order 13847, 83 FR 45321, directed the IRS to review the life expectancy and distribution tables to determine if they should be updated to reflect current mortality data, and how often such tables should be updated. In November 2019 the IRS released proposed regulations containing proposed updated tables.

Longer Life Expectancy Tables

In the preamble to the final regulations, the IRS provides the following description of the changes that were made:

> The life expectancy tables and applicable distribution period tables in these regulations generally reflect longer life expectancies than the tables in formerly applicable §1.401(a)(9)-9. For example, a 72-year-old IRA owner who applied the Uniform Lifetime Table under formerly applicable §1.401(a)(9)-9 to calculate required minimum distributions used a life expectancy of 25.6 years. Applying the Uniform Lifetime Table set forth in these regulations, a 72-year-old IRA owner will use a life expectancy of 27.4 years to calculate required minimum distributions. As another example, a 75-year-old surviving spouse who is the employee's sole beneficiary and applied the Single Life Table under formerly applicable §1.401(a)(9)-9 to compute required minimum distributions used a life expectancy of 13.4 years.

[356] Revenue Procedure 2021-14, Section 5.03

[357] TD 9930, November 5, 2020, https://public-inspection.federalregister.gov/2020-24723.pdf (retrieved November 6, 2020)

Under these regulations, a 75-year-old surviving spouse will use a life expectancy of 14.8 years. The effect of these changes is to reduce required minimum distributions generally, which will allow participants to retain larger amounts in their retirement plans to account for the possibility they may live longer.[358]

The updated Uniform Lifetime Table,[359] used to calculate the required minimum distributions, is provided below:

Age of employee	Distribution period
72	27.4
73	26.5
74	25.5
75	24.6
76	23.7
77	22.9
78	22.0
79	21.1
80	20.2
81	19.4
82	18.5
83	17.7
84	16.8
85	16.0
86	15.2
87	14.4
88	13.7
89	12.9

358 TD 9930, Summary of Comments and Explanation of Provisions, I. Overview
359 Reg. §1.401(a)(9)-9(c)

90	12.2
91	11.5
92	10.8
93	10.1
94	9.5
95	8.9
96	8.4
97	7.8
98	7.3
99	6.8
100	6.4
101	6.0
102	5.6
103	5.2
104	4.9
105	4.6
106	4.3
107	4.1
108	3.9
109	3.7
110	3.5
111	3.4
112	3.3
113	3.1
114	3.0

115	2.9
116	2.8
117	2.7
118	2.5
119	2.3
120	2.0

This table is described by the IRS as follows in the preamble to the regulations:

> The Uniform Lifetime Table in these regulations sets forth joint and last survivor life expectancies for each age beginning with age 72, based on a hypothetical beneficiary. Pursuant to §1.401(a)(9)-5, Q&A-4(a), the Uniform Lifetime Table is used for determining the distribution period for lifetime distributions to an employee in situations in which the employee's surviving spouse either is not the sole designated beneficiary or is the sole designated beneficiary but is not more than 10 years younger than the employee. The joint and last survivor life expectancy of an employee is taken from the Joint and Last Survivor Table using a hypothetical beneficiary who is assumed to be 10 years younger than the employee.[360]

In a footnote, the IRS reminds readers why the revised table starts at age 72 rather than 70:

> The proposed regulations included Uniform Lifetime Table entries beginning with age 70. These regulations do not include Uniform Lifetime Table entries for ages 70 and 71 because section 114 of the SECURE Act changed the minimum age for receiving required minimum distributions from age 70½ to age 72.[361]

The regulation also provides updates to the following tables:

- Single life table;[362]
- Joint and last survivor life table;[363] and

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[360] TD 9930, Summary of Comments and Explanation of Provisions, III. Updated Life Expectancy and Distribution Period Tables

[361] TD 9930, Summary of Comments and Explanation of Provisions, III. Updated Life Expectancy and Distribution Period Tables, Footnote 14

[362] Reg. §1.409(a)(9)-9(b)

[363] Reg. §1.409(a)(9)-9(d)

- Mortality rates table.[364]

Upcoming Ruling on Substantially Equal Periodic Payments

The preamble notes that the agency will be issuing a ruling on applying these new provisions to substantially equal periodic payments:

> The Treasury Department and the IRS anticipate issuing guidance that would update Rev. Rul. 2002-62. This update would apply the life expectancy, distribution period, and mortality tables set forth in these regulations for purposes of determining substantially equal periodic payments once these regulations become effective.[365]

Applicability Dates

The regulations provide details on how and when the new regulations will apply to distributions:

> The life expectancy tables and Uniform Lifetime Table set forth in this section apply for distribution calendar years beginning on or after January 1, 2022. For life expectancy tables and the Uniform Lifetime Table applicable for earlier distribution calendar years, see §1.401(a)(9)-9, as set forth in 26 CFR part 1 revised as of April 1, 2020 (formerly applicable §1.401(a)(9)-9).[366]

The regulations contain additional guidance on the use of these tables for life expectancies that may be recalculated:

> If an employee died before January 1, 2022, and, under the rules of §1.401(a)(9)-5, the distribution period that applies for a calendar year following the calendar year of the employee's death is equal to a single life expectancy calculated as of the calendar year of the employee's death (or, if applicable, the following calendar year), reduced by 1 for each subsequent year, then that life expectancy is reset as provided in paragraph (f)(2)(ii) of this section.[367]

The redetermination under this provision is to be handled via these rules

> With respect to a life expectancy described in paragraph (f)(2)(i) of this section, the distribution period that applies for a distribution calendar year beginning on or after January 1, 2022, is determined by using the

[364] Reg. §1.409(a)(9)-9(e)

[365] TD 9930, Summary of Comments and Explanation of Provisions, V. Use of Revised Tables to Determine Substantially Equal Periodic Payments

[366] Reg. §1.409(a)(9)-9(f)(1)

[367] Reg. §1.409(a)(9)-9(f)(2)(i)

> Single Life Table in paragraph (b) of this section to determine the initial life expectancy for the age of the relevant individual in the relevant calendar year and then reducing the resulting distribution period by 1 for each subsequent year. However, see section 401(a)(9)(H)(ii) and (iii) for rules limiting the availability of a life expectancy distribution period.[368]

The regulation provides the following example of applying this rule:

EXAMPLE, REG. §1.409(A)(9)-9(F)(2)(II)(B), REDETERMINATION

Assume that an employee died at age 80 in 2019 and the employee's designated beneficiary (who was not the employee's spouse) was age 75 in the year of the employee's death. For 2020, the distribution period that would have applied for the beneficiary was 12.7 years (the period applicable for a 76- year-old under the Single Life Table in formerly applicable §1.401(a)(9)-9), and for 2021, it would have been 11.7 years (the original distribution period, reduced by 1 year). For 2022, if the designated beneficiary is still alive, then the applicable distribution period would be 12.1 years (the 14.1-year life expectancy for a 76-year-old under the Single Life Table in paragraph (b) of this section, reduced by 2 years). However, see section 401(a)(9)(H)(iii) for rules regarding how to apply the required distribution rules to defined contribution plans if the eligible designated beneficiary dies prior to distribution of the employee's entire interest.

The regulation provides for the following if the employee's sole beneficiary was the employee's surviving spouse:

> Similarly, if an employee's sole beneficiary is the employee's surviving spouse, and the spouse dies before January 1, 2022, then the spouse's life expectancy for the calendar year of the spouse's death (which is used to determine the applicable distribution period for later years) is reset as provided in paragraph (f)(2)(ii) of this section.[369]

The proposed regulations originally would have had these regulations apply for 2021—so why do the final regulations push this liberalization back to 2022? The IRS explains this change in the effective date in the preamble:

> A number of commenters also requested that the effective date of the final regulations be delayed to 2022 (instead of 2021). They noted that plan sponsors and IRA providers are currently working to update their systems for the SECURE Act changes to section 401(a)(9) and recommended that the effective date of these regulations be delayed in order to allow administrators sufficient additional time to update systems for these regulations. As described in the

[368] Reg. §1.409(a)(9)-9(f)(2)(ii)(A)

[369] Reg. §1.409(a)(9)-9(f)(2)(i)

> Effective/Applicability Date section of this preamble, these regulations will apply to distribution calendar years beginning on or after January 1, 2022.[370]

SECTION: 1031
FINAL REGULATION ISSUED DEFINING REAL PROPERTY FOR TCJA REVISION TO §1031

Citation: TD 9935, Reg. §1.1031-3, 11/23/20

The Tax Cuts and Jobs Act limited like-kind exchanges under §1031 to exchanges of real property effective January 1, 2018. The IRS issued proposed regulations in June 2020[371] to implement these revisions in §1031. In November 2020 the IRS finalized these regulations after making certain changes.[372]

Summary of Changes from the Proposed Regulations

The preamble to the final regulations contains the following overview of the key changes found in the final regulations as compared to the proposed regulations issued five months earlier. First, it notes that the final regulations modify the definition of real property to now refer to the appropriate state and local law definition of real property:

> The final regulations retain the basic approach and structure of the proposed regulations, with certain revisions. In particular, the final regulations revise the definition of "real property" in the proposed regulations to provide that property is classified as real property for section 1031 purposes if, on the date it is transferred in an exchange, the property is real property under the law of the State or local jurisdiction in which that property is located.[373]

The final regulations also remove the "purpose or use test" that was found in the proposed regulations from the definition of real property:

> The final regulations also revise the proposed definition of real property to eliminate, with regard to both tangible and intangible properties, any consideration of whether the particular property contributes to the production of income unrelated to the use or occupancy of space (referred to as the "purpose or use test," as defined

[370] TD 9930, SUPPLEMENTARY INFORMATION, Background, II. Regulations under Section 401(a)(9)
[371] REG-117589-18, June 11, 2020, https://s3.amazonaws.com/public-inspection.federalregister.gov/2020-11530.pdf (retrieved June 12, 2020)
[372] TD 9935, November 24, 2020 (Pre-release version posted on IRS website), https://www.irs.gov/pub/irs-drop/td_9935.pdf (retrieved November 24, 2020)
[373] TD 9935, November 24, 2020, Summary of Comments and Explanation of Revisions, I. Overview

> in part II.B.1 of this Summary of Comments and Explanation of Revisions).[374]

The final regulations continue to contain a warning that these rules apply solely for purposes of §1031, and do not impact other provisions of the IRC:

> Finally, in §1.1031(a)-3(a)(7), the final regulations retain the language of the proposed regulations clarifying that the rules of these final regulations apply only for purposes of section 1031 and that no inference is intended with respect to the classification or characterization of property for other purposes of the Code.[375]

Key Revisions to Real Property Definitions for §1031

The proposed regulations in most cases ignored whether state and local law considered something to be real property, aiming for a standard federal definition to be applied in most cases. However, this attracted a number of comments arguing against this approach:

> Commenters generally critiqued the apparent scope of the application of State and local law in the proposed regulations for purposes of defining real property. These commenters contended that, prior to enactment of the TCJA, State and local law classification of a property often was the determining factor in characterizing property as real or personal under section 1031. With regard to the Conference Report Example, the commenters asserted that the reference to "shares in a mutual ditch, reservoir, or irrigation company" merely constituted a set of examples that Congress provided to broadly indicate that real property eligible for like-kind treatment under law prior to enactment of the TCJA will continue to be eligible following the TCJA's amendment to section 1031. Consequently, the commenters recommended that the final regulations conform to that intent by expanding the rules to rely significantly, or wholly, on State-law classifications for all assets, rather than limiting such reliance to shares in a mutual ditch, reservoir, or irrigation company. Additionally, commenters suggested that the final regulations should include multiple examples of instances in which taxpayers may rely on State or local law for purposes of classifying property as real or personal.[376]

Thus, the IRS describes the following changes found in the final regulations:

[374] TD 9935, November 24, 2020, Summary of Comments and Explanation of Revisions, I. Overview

[375] TD 9935, November 24, 2020, Summary of Comments and Explanation of Revisions, I. Overview

[376] TD 9935, November 24, 2020, Summary of Comments and Explanation of Revisions, II. Definition of Real Property, A. State or local law definitions of real property, 2. Consideration of Comments and Revision of "Real Property" Definition

> …[T]he final regulations provide generally that property is real property for purposes of section 1031 if, on the date it is transferred in an exchange, that property is classified as real property under the law of the State or local jurisdiction in which that property is located (State and local law test). The State and local law test applies to both tangible and intangible property classifications.[377]

While this is true in most cases, the IRS did exclude some property from the definition to be consistent with prior law:

> However, consistent with Congressional intent that "real property eligible for like-kind exchange treatment" under the law in effect prior to enactment of the TCJA will continue to be eligible for like-kind exchange treatment after enactment of the TCJA, property ineligible for like-kind exchange treatment prior to enactment of the TCJA remains ineligible, including real property that was excluded from the application of section 1031. See Conference Report at 396, fn. 726. Prior to amendment by the TCJA, former section 1031(a)(2) explicitly excluded certain assets from the application of section 1031. Accordingly, the final regulations exclude from the definition of real property the intangible assets listed in section 1031(a)(2) prior to its amendment by the TCJA, regardless of the classification of the property under State or local law, because such property never was "real property eligible for like-kind exchange treatment" prior to enactment of the TCJA. Conference Report at 396, fn. 726 (emphasis added).
>
> In summary, under the final regulations, property is classified as real property for purposes of section 1031 if the property is (i) so classified under the State and local law test, subject to certain exceptions, (ii) specifically listed as real property in the final regulations, or (iii) considered real property based on all the facts and circumstances under the various factors provided in the final regulations. A determination that property is personal property under State or local law does not preclude the conclusion that property is real property as specifically listed in §1.1031(a)-3(a)(2)(ii) or (a)(2)(iii)(B) or as real property under the factors listed in §1.1031(a)-3(a)(2)(ii)(C) or (a)(2)(iii)(B).[378]

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[377] TD 9935, November 24, 2020, Summary of Comments and Explanation of Revisions, II. Definition of Real Property, A. State or local law definitions of real property, 2. Consideration of Comments and Revision of "Real Property" Definition

[378] TD 9935, November 24, 2020, Summary of Comments and Explanation of Revisions, II. Definition of Real Property, A. State or local law definitions of real property, 2. Consideration of Comments and Revision of "Real Property" Definition

Definition of Real Property for §1031

The regulations add new Reg. §1.1031-3, Definition of Real Property.

The new regulation begins by defining *real property* as:

- Land;
- Improvements to land;
- Unsevered natural products of land; and
- Water and airspace adjacent to land.[379]

Property that is real property under state or local law where the property is located is real property for purposes of §1031[380] except for certain intangible assets described in Reg. §1.1031(a)-3(a)(5).

Such intangible assets that are *not* real property are:

- Stock (other than stock in a cooperative housing corporation and shares in a mutual ditch, reservoir, or irrigation company), bonds or notes;
- Other securities or evidence of indebtedness;
- Interests in a partnership (other than those with a valid election under IRC §761(a) to be excluded from subchapter K);
- Certificates of trust or beneficial interests; and
- Choses in action.[381]

Conversely, the regulation holds that the following intangible interests will qualify as real property:

> Intangible assets that are real property for purposes of section 1031 and this section include the following items: fee ownership; co-ownership; a leasehold; an option to acquire real property; an easement; stock in a cooperative housing corporation; shares in a mutual ditch, reservoir, or irrigation company described in section 501(c)(12)(A) of the Code if, at the time of the exchange, such shares have been recognized by the highest court of the State in which the company was organized, or by a State statute, as constituting or representing real property or an interest in real property; and land

[379] Reg. §1.1031(a)-3(a)(1)
[380] Reg. §1.1031(a)-3(a)(1), (a)(6)
[381] Reg. §1.1031(a)-3(a)(5)

> development rights. Similar interests are real property for purposes of section 1031, and this section if the intangible asset derives its value from real property or an interest in real property and is inseparable from that real property or interest in real property.[382]

The regulation also makes clear that these definitions are *solely* for the purposes of §1031 and do not apply to other provisions in the IRC:

> The rules provided in this section concerning the definition of real property apply only for purposes of section 1031. No inference is intended with respect to the classification or characterization of property for other purposes of the Code, such as depreciation and sections 1245 and 1250. For example, a structure or a portion of a structure may be section 1245 property for depreciation purposes and for determining gain under section 1245, notwithstanding that the structure or the portion of the structure is real property under this section. Also, a taxpayer transferring relinquished property that is section 1245 property in a section 1031 exchange is subject to the gain recognition rules under section 1245 and the regulations under section 1245, notwithstanding that the relinquished property or replacement property is real property under this section. In addition, the taxpayer must follow the rules of section 1245 and the regulations under section 1245, and section 1250 and the regulations under section 1250, based on the determination of the relinquished property and replacement property being, in whole or in part, section 1245 property or section 1250 property under those Code sections and not under this section.[383]

Reg. §1.1031-3(a) continues by providing detailed definitions of various classes of assets.

Distinct Asset

Several of the definitions reference a *distinct asset*, a term defined in the regulations. The regulations provide:

> For this section, a distinct asset is analyzed separately from any other assets to which the asset relates to determine if the asset is real property, whether as land, an inherently permanent structure, or a structural component of an inherently permanent structure. Buildings and other inherently permanent structures are distinct assets. Assets and systems listed as a structural component in paragraph (a)(2)(iii)(B) of this section are treated as distinct assets.[384]

[382] Reg. §1.1031(a)-3(a)(5)
[383] Reg. §1.1031(a)-3(a)(7)
[384] Reg. §1.1031(a)-3(a)(4)(i)

The regulation provides the following test to determine if an item is a distinct asset for the purposes of these regulations:

> The determination of whether a particular separately identifiable item of property is a distinct asset is based on all the facts and circumstances. In particular, the following factors must be taken into account--
>
> (A) Whether the item is customarily sold or acquired as a single unit rather than as a component part of a larger asset;
>
> (B) Whether the item can be separated from a larger asset, and if so, the cost of separating the item from the larger asset;
>
> (C) Whether the item is commonly viewed as serving a useful function independent of a larger asset of which it is a part; and
>
> (D) Whether separating the item from a larger asset of which it is a part impairs the functionality of the larger asset..[385]

Improvements to Land

Improvements to land include:

- Inherently permanent structures and
- Structural components of inherently permanent structures.[386]

Inherently Permanent Structures

The regulation defines *inherently permanent structures* as “any building or other structure that is a distinct asset” that is permanently affixed to real property and “will ordinarily remain affixed for an indefinite period of time.”[387]

A *building* is defined as:

> …any structure or edifice enclosing a space within its walls, and covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space.[388]

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[385] Reg. §1.1031(a)-3(a)(4)(ii)
[386] Reg. §1.1031(a)-3(a)(2)(i)
[387] Reg. §1.1031(a)-3(a)(2)(ii)(A)
[388] Reg. §1.1031(a)-3(a)(2)(ii)(B)

The regulations provide that buildings include the following distinct assets if permanently affixed:

- Houses
- Apartments
- Hotels and motels:
- Enclosed stadiums and arenas
- Enclosed shopping malls
- Factories and office buildings
- Warehouses
- Barns
- Enclosed garages
- Enclosed transportation stations and terminals and
- Stores.[389]

Other inherently permanent structures include the following items if permanently affixed:

> … in-ground swimming pools; roads; bridges; tunnels; paved parking areas, parking facilities, and other pavements; special foundations; stationary wharves and docks; fences; inherently permanent advertising displays for which an election under section 1033(g)(3) is in effect; inherently permanent outdoor lighting facilities; railroad tracks and signals; telephone poles; power generation and transmission facilities; permanently installed telecommunications cables; microwave transmission, cell, broadcasting, and electric transmission towers; oil and gas pipelines; offshore platforms, derricks, oil and gas storage tanks; and grain storage bins and silos.[390]

The regulation provides the following guidance to determine if an asset is permanently affixed:

> Affixation to real property may be accomplished by weight alone. If property is not listed as an inherently permanent structure in paragraph (a)(2)(ii)(B) or (C) of this section, the determination of

[389] Reg. §1.1031(a)-3(a)(2)(ii)(B)
[390] Reg. §1.1031(a)-3(a)(2)(ii)(C)

whether the property is an inherently permanent structure under paragraph (a)(2)(ii) of this section is based on the following factors--

(1) The manner in which the distinct asset is affixed to real property;

(2) Whether the distinct asset is designed to be removed or to remain in place;

(3) The damage that removal of the distinct asset would cause to the item itself or to the real property to which it is affixed;

(4) Any circumstances that suggest the expected period of affixation is not indefinite; and

(5) The time and expense required to move the distinct asset.[391]

Structural Components

A *structural component* is a distinct asset "that is a constituent part of, and integrated into, an inherently permanent structure."[392] The regulation notes that "[i]f interconnected assets work together to serve an inherently permanent structure (for example, systems that provide a building with electricity, heat, or water), the assets are analyzed together as one distinct asset that may be a structural component."[393]

The regulation provides the following additional detailed rules for structural components:

- If a distinct asset is customized, the customization does not affect whether the distinct asset is a structural component.
- Tenant improvements to a building that are inherently permanent or otherwise classified as real property are real property.
- Property produced for sale, such as bricks, nails, paint, and windowpanes, that is not real property in the hands of the producing taxpayer or a related person, but that may be incorporated into real property by an unrelated buyer, is not treated as real property by the producing taxpayer.[394]

So long as the following items are a constituent part of and integrated into an inherently permanent item, they are treated as structural components for purposes of §1031:

- Walls;

[391] Reg. §1.1031(a)-3(a)(2)(ii)(C)
[392] Reg. §1.1031(a)-3(a)(2)(iii)(A)
[393] Reg. §1.1031(a)-3(a)(2)(iii)(A)
[394] Proposed Reg. §1.1031(a)-3(a)(2)(iii)(A)

- Partitions;
- Doors;
- Wiring;
- Plumbing systems;
- Central air conditioning and heating systems;
- Pipes and ducts;
- Elevators and escalators;
- Floors;
- Ceilings;
- Permanent coverings of walls, floors, and ceilings;
- Insulation;
- Chimneys;
- Fire suppression systems, including sprinkler systems and fire alarms;
- Fire escapes;
- Security systems;
- Humidity control systems; and
- Other similar property.[395]

For other items not included in the list, the regulation provides the following test to be used to determine if the item is a structural component:

> If a component of a building or inherently permanent structure is a distinct asset and is not listed as a structural component in this paragraph (a)(2)(iii)(B), the determination of whether the component is a structural component under this paragraph (a)(2)(iii) is based on the following factors--
>
> (1) The manner, time, and expense of installing and removing the component;
>
> (2) Whether the component is designed to be moved;

[395] Reg. §1.1031(a)-3(a)(2)(iii)(B)

(3) The damage that removal of the component would cause to the item itself or to the inherently permanent structure to which it is affixed; and

(4) Whether the component is installed during construction of the inherently permanent structure.[396]

Unsevered Natural Products of Land

Real property for §1031 purposes includes *unsevered products of land* which is defined to include:

- Growing crops plants, and timber;
- Mines;
- Wells; and
- Other natural deposits.[397]

The regulation goes on to note that "[n]atural products and deposits, such as crops, timber, water, ores, and minerals, cease to be real property when they are severed, extracted, or removed from the land."[398]

EXAMPLES

The regulation provides a series of twelve examples of applying these rules, found at Reg. §1.031-3(b). Advisers should look at these examples to become comfortable with how the IRS sees these rules being applied in specific situations. As is always true, pay special attention to the facts in each example that the IRS references in making the determination of whether the item is or is not real property.

The topics covered by the examples are:

- Example 1: Natural products of land
- Example 2: Water space superjacent to land
- Example 3: Indoor sculpture (an interesting example as it shows how an item not attached to other real property can nevertheless become real property due to its weight and the impracticality of moving the object)
- Example 4: Bus shelters (an illustration of the opposite conclusion to Example 3, the shelters in this case are found not to be real property)

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[396] Reg. §1.1031(a)-3(a)(2)(iii)(B)
[397] Reg. §1.1031(a)-3(a)(3)
[398] Reg. §1.1031(a)-3(a)(3)

- Example 5: Industrial 3D Printer (this example now arrives at a different result than it did in the proposed regulations. The final regulations no longer remove machinery from the category of real property so long as it meets the other requirements for property not specifically listed as a structural component. Also, now old example 6 is deleted, as it no longer matters if a generator supplies power to the entire building or just the 3D printer)

- Example 6 (previously 7 in the proposed regulations): Raised flooring for Industrial 3D Printer (continuing with the 3D printer issue, this example finds the raised flooring for the 3D printer is not real property given the facts of the example)

- Example 7 (previously 8 in the proposed regulations): Steam Turbine (another reversal of position vs. the same example in the proposed regulations, this time the IRS finding the turbine is real property.)

- Example 8 (previously 9 in the proposed regulations): Partitions (while a conventional partition system is found to be real property, a modular partition system is found not to be real property)

- Example 9 (previously 10 in the proposed regulations): Pipeline transmission system (the pipeline and isolation valves are found to be real property, but meters are not)

- Example 10 (new with the final regulations): State or local law determination of property. Illustrates that if an item is listed in the regulations as real property (cell towers in this case), it is not relevant if state law provides they are not real property.

- Example 11: Land use permit. (a right to use land owned by the Federal government to put up a cell tower is found to be real property)

- Example 12: License to operate a business. (even though limited to a particular location, this license is not real property).

Incidental Personal Property Safe Harbor

In addition to the definition of real property, the IRS addressed concerns about the receipt of incidental amounts of personal property by a qualified intermediary destroying a like-kind exchange based on existing rules. As the IRS described the issue in the preamble to the proposed regulations:

> The Treasury Department and the IRS are aware that taxpayers have questioned the effect of the receipt of personal property that is incidental to the taxpayer's replacement real property in an intended section 1031 exchange. For example, taxpayers have asked whether an exchange fails to meet the requirements of §1.1031(k)-1(g)(6)(i) if funds from the transfer of relinquished property held by the qualified intermediary are used to acquire an office building, including the

> personal property in the office building. Taxpayers and qualified intermediaries are concerned that a taxpayer would be considered to be in constructive receipt of all of the exchange funds held by the qualified intermediary if the taxpayer is able to direct the qualified intermediary to use those funds to acquire property that is not of a like kind to the taxpayer's relinquished property. Under §1.1031(k)-1(a), if a taxpayer actually or constructively receives the funds held by a qualified intermediary before receiving the replacement property, the transaction is a sale and not a section 1031 like-kind exchange.[399]

The preamble goes on to describe the solution provided for this issue, creating a special rule allowing the receipt of such property to be disregarded if the receipt of personal property is incidental to the overall exchange of real property:

> In response to these inquiries, the proposed regulations add to the items in §1.1031-1(g)(7) that are disregarded in determining whether the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary. The proposed regulations provide that personal property that is incidental to replacement real property is disregarded in determining whether a taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by a qualified intermediary are expressly limited as provided in §1.1031(k)-1(g)(6). Personal property is incidental to real property acquired in an exchange if, in standard commercial transactions, the personal property is typically transferred together with the real property, and the aggregate fair market value of the incidental personal property transferred with the real property does not exceed 15 percent of the aggregate fair market value of the replacement real property. This incidental property rule in the proposed regulations is based on the existing rule in §1.1031(k)-1(c)(5), which provides that certain incidental property is ignored in determining whether a taxpayer has properly identified replacement property under section 1031(a)(3)(A) and §1.1031(k)-1(c).[400]

The proposed regulations would insert the following into existing Reg. §1.1031(k)-1(g)(7):

> (iii) Personal property generally resulting in gain recognition under section 1031(b) that is incidental to real property acquired in an exchange. For purposes of this paragraph (g)(7), personal property is incidental to real property acquired in an exchange if--

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399 REG-117589-18, SUPPLEMENTARY INFORMATION, Explanation of Provisions, Section II

400 REG-117589-18, SUPPLEMENTARY INFORMATION, Explanation of Provisions, Section II

(A) In standard commercial transactions, the personal property is typically transferred together with the real property; and

(B) The aggregate fair market value of the property described in paragraph (g)(7)(iii)(A) of this section transferred with the real property does not exceed 15 percent of the aggregate fair market value of the replacement real property or properties received in the exchange.[401]

The IRS provided the following example of the application of this provision:

EXAMPLE (REG. §1.1031(K)-1(G)(8)(VII))

Example 6. ((A) In 2020, B transfers to C real property with a fair market value of $1,100,000 and an adjusted basis of $400,000. B's replacement property is an office building and, as a part of the exchange, B also will acquire certain office furniture in the building that is not real property, which is industry practice in a transaction of this type. The fair market value of the real property B will acquire is $1,000,000 and the fair market value of the personal property is $100,000.

(B) In a standard commercial transaction, the buyer of an office building typically also acquires some or all of the office furniture in the building. The fair market value of the personal property B will acquire does not exceed 15 percent of the fair market value of the office building B will acquire. Accordingly, under paragraph (g)(7)(iii) of this section, the personal property is incidental to the real property in the exchange and is disregarded in determining whether the taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of money or non-like-kind property are expressly limited as provided in paragraph (g)(6) of this section. Upon the receipt of the personal property, B recognizes gain of $100,000 under section 1031(b), the lesser of the realized gain on the disposition of the relinquished property, $700,000, and the fair market value of the non-like-kind property B acquired in the exchange, $100,000.

[401] Reg. §1.1031(k)-1(g)(7)(iii)

SECTION: 1402
ELEVENTH CIRCUIT AFFIRMS TAX COURT RULING THAT AUTHOR HAD TO TREAT ALL OF HER PUBLISHING CONTRACT INCOME AS SELF-EMPLOYMENT INCOME

Citation: Slaughter *v.* Commissioner, No. 20-10786, CA 11, 8/3/21

The Eleventh Circuit Court of Appeals upheld the Tax Court's decision regarding self-employment income in the case of *Slaughter v. Commissioner*.[402] In this case, an author argued that most of the income she received from her publishing contract was for activities other than the time she spent writing books. She argued that payments for anything other than time spent writing a book was not income from a trade or business for self-employment tax purposes.

The case involves bestselling crime fiction author Karin Slaughter. The opinion describes her income received from her publishing contracts as follows:

> During the years relevant to this appeal, Slaughter received income for her books through contracts with publishers. Her contractual obligations varied with the publisher. For English-language publishers, Slaughter was required to write an original manuscript for a book. If the manuscript was delivered to and accepted by the publisher, she received a fixed advance payment in installments specified in her contract. Slaughter also received royalties or subsidiary rights income from those sales if they exceeded her advance. For foreign-language publishers, Slaughter also received similar advances in exchange for the right to print, publish, and sell a foreign-language translation of one of her existing books.
>
> Since signing her first publishing contract in 1999, Slaughter has retained the same literary agent to help promote her work with publishers, booksellers, and book reviewers. Slaughter and her agent promote her brand in several ways: maintaining contact with her readership through her website, newsletter, and social media presence; giving interviews; attending promotional and publicity events; giving gifts to business associates and inviting publishers to stay with her in her home; renting an apartment in New York City to attend trade shows and meet publishers there; and paying for a promotional bus poster. Significantly, Slaughter claimed business-expense deductions

[402] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/eleventh-circuit-affirms-author-is-liable-for-self-employment-taxes/76zkq (retrieved August 3, 2021)

> for all of those activities on her income tax returns for 2010 and 2011.[403]

For the two years involved in the case, Ms. Slaughter received income of over $5.4 million and $3.6 million from her publishing work. On her return, this income was divided between business and non-business income using the following method:

> In allocating Slaughter's publishing income for both returns, her accountants began with the fact that she took 12 to 15 weeks to write a book and wrote approximately one book per year. For her 2010 return, they assumed that Slaughter worked five days a week for 12 weeks, meaning that she worked 60 days that year. And because 60 days is about 16.43% of a 365-day year, they reported that percentage of Slaughter's publishing income as her gross business income. For her 2011 return, they used the same method but calculated a higher percentage of publishing income to report as her gross business income because Slaughter had spent more time writing that year.[404]

The IRS objected to this division of income, finding that all of the income she received was derived from her trade or business of writing books. The United States Tax Court agreed with the IRS, treating all income received by Ms. Slaughter on these contracts as self-employment income. Ms. Slaughter appealed the decision to the Eleventh Circuit Court of Appeals.

Ms. Slaughter argued that her promotional activities should not be treated as part of her trade or business.

> Here, Slaughter argues that her trade or business does not include promotional activities because they were only sporadic and occasional rather than continuous and regular. And she further argues that when the tax court found otherwise, it failed to provide specific details about the time, duration, and frequency of her promotional activities or explain why those activities were continuous and regular in 2010 and 2011.[405]

As the opinion notes, Ms. Slaughter is correct that an activity that is sporadic will not rise to the level of a trade or business:

> Section 1402(c) defines "[t]he term 'trade or business,' when used with reference to self-employment income or net earnings from self-employment" to "have the same meaning as when used in section 162" of the Tax Code, with limited exceptions that are not applicable to this appeal. 26 U.S.C. § 1402(c). The Supreme Court has held that to be

[403] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021
[404] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021
[405] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021

> engaged in a trade or business under Section 162, "the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit." *Comm'r v. Groetzinger,* 480 U.S. 23, 35 (1987). "A sporadic activity, a hobby, or an amusement diversion does not qualify." *Id.*[406]

However, the panel did not agree with her view that this applied to her promotional activities:

> First, determining whether an activity is sufficiently continuous and regular to constitute a trade or business "requires an examination of the facts in each case." Id. at 36 (quoting *Higgins v. Comm'r*, 312 U.S. 212, 217 (1941)). Consequently, we review the tax court's findings on that issue for clear error. "A factual finding is clearly erroneous when a review of the entire record leaves us with the definite and firm conviction that a mistake has been committed." *Berenguela-Alvarado v. Castanos*, 950 F.3d 1352, 1357 (11th Cir. 2020) (internal quotation marks omitted). Yet whatever doubts might exist about the tax court's findings here, they rise nowhere near the level of certainty required for clear error.

One key problem the panel pointed out was the fact that Ms. Slaughter claimed deductions related to expenses incurred for her promotional activities—deductions that could only have been allowed as trade or business expenses under IRC §162(a):

> For example, Slaughter's prior business-expense deductions amply support the tax court's finding. As the IRS noted throughout the proceedings below, those deductions were for (1) the rent for Slaughter's New York apartment that she used when going to trade shows and meeting with publishers, (2) payments for a car — which was the same model used by her main character Sara Linton — that she drove to interviews and promotional and networking events, (3) catering expenses and gifts for business associates, and (4) expenses for advertising, her website, and "promotions." Slaughter could not have claimed deductions for those expenses unless they were paid or incurred "in carrying on any trade or business." 26 U.S.C. § 162(a). That Slaughter deducted these expenses illustrates that the promotion of her written work was part of her writing business. Indeed, the promotion and sale of books is a key factor distinguishing a writing business, which one engages in for income and profit, from a writing hobby.[407]

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[406] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021

[407] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021

The Court also found that Ms. Slaughter had conceded that writing was conducted frequently enough to rise to a trade or business even though she spent relatively small amounts of time writing each year, less than she spent on the promotional activities she argued were sporadic:

> Second, Slaughter's insistence that her promotional activities were interrupted and not full time — and therefore too sporadic and occasional to be a part of her trade or business — is inconsistent with her own position. Although Slaughter maintains that her trade or business is limited to the physical labor of writing — the act of putting pen to paper or finger to key — she spent only approximately 16 and 25 percent of 2010 and 2011, respectively, engaged in that labor. By Slaughter's own definition, her writing — an indisputably core part of her trade or business — would qualify only as "sporadic and occasional." Both common sense and Slaughter's own position therefore require that her promotional activities be considered part of her trade or business. *Helvering v. Horst*, 311 U.S. 112, 118 (1940) ("Common understanding and experience are the touchstones for the interpretation of the revenue laws.").[408]

Ms. Slaughter also argued that even if promotion was part of her trade or business, the IRS failed to show the entire amount of her publishing income was sufficiently connected with the trade or business to be self-employment income:

> Slaughter also argues that the tax court erred in finding that all of her publishing income in 2010 and 2011 was derived from her trade or business. This argument differs from her first argument: the fact that Slaughter's promotional activities were a part of her trade or business does not automatically mean that all of her publishing income was derived from her trade or business.[409]

The opinion goes on to explain what would be necessary to show that income is related to a trade or business:

> We have held that for self-employment income to be derived from a trade or business, "there must be a nexus between the income received and a trade or business that is, or was, actually carried on." *Peterson*, 827 F.3d at 986 (cleaned up). Additionally, "the income must arise from some actual (whether present, past, or future) income-producing activity of the taxpayer before such income becomes subject to self-employment taxes." *Id*. (cleaned up). Nonetheless, "[t]he self-employment tax provisions are broadly construed to favor treatment of

[408] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021

[409] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021

> income as earnings from self-employment." *Id.* (quoting *Bot v. Comm'r*, 353 F.3d 595, 599 (8th Cir. 2003)).[410]

Ms. Slaughter argues that income from her intangible assets is not self-employment income, lacking sufficient nexus to the writing business:

> Here, Slaughter argues that income from her intangible assets — specifically the rights to her name and likeness, access to her readership, the right to use characters from her previous books, and noncompetition agreements — is not subject to self-employment tax because there is no nexus between that income and her trade or business. In support of this argument, she cites a Ninth Circuit decision stating that the nexus test is satisfied only if the "earnings [are] tied to the quantity or quality of the taxpayer's prior labor, rather than the mere fact that the taxpayer worked or works for the payor." *Milligan v. Comm'r*, 38 F.3d 1094, 1098 (9th Cir. 1994).[411]

The panel first points out that the Eleventh Circuit only has applied *Milligan* in the specific type of situation that existed in that case—which was not that of being author:

> We have declined to apply the Ninth Circuit's quantity-or-quality test beyond the context of post-termination payments to insurance agents. See *Peterson*, 827 F.3d at 992–93 (describing *Milligan* as "nonbinding," "distinguish[ing] [that] insurance case[ ] on at least four bases," and concluding that "the after-termination payments of insurance salesmen" in that case were not "comparable" outside its facts).[412]

As well, the opinion goes on to hold that even if the Ninth Circuit's test were to be applied in this situation, Ms. Slaughter would still not prevail:

> And even if the Ninth Circuit's test did apply here, we think that all of Slaughter's publishing income — including the portions from her intangible assets — readily satisfies it. If Slaughter ceased to write or promote her books, then her brand and success as an author would be affected. If she were not writing books, publishers would pay less — or even nothing — for her name and likeness, access to her readership, the right to use her characters, and her agreements not to compete.[413]

[410] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021
[411] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021
[412] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021
[413] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021

The panel found that the licensing of her likeness and name was tied directly to her writing of books:

> Regarding her name and likeness, she avers that their licensing "can[not] be reasonably described as used predominantly for profit rather than as a personal right." She then concludes that income from that licensing cannot be derived from her trade or business because trade or business activity must have the primary purpose of profit. Although she is correct that trade or business activity must be primarily profit-motivated, there is no reason to believe that Slaughter — a longtime bestselling author who has earned millions of dollars from her books — licensed her name and likeness for use on books and related materials for any purpose other than increasing her profit. [414]

Similarly, the panel did not find that she could carve out a portion of her contracts related to a non-competition clause from self-employment income given the nature of such clauses in her contracts:

> As for her noncompetition agreements, Slaughter avers that income from an agreement not to compete does not derive from a trade or business. But the supporting caselaw that Slaughter cites in fact undermines her assertion. As she correctly notes, the tax court has previously addressed "whether noncompetition under a covenant not to compete constitutes a trade or business[.]" *Ohio Farm Fed'n, Inc. v. Comm'r*, 106 T.C. 222, 234 (1996). But contrary to her suggestion, the tax court did not categorically exclude such noncompetition from being a trade or business. Instead, it held that the standard continuity-and-regularity test applied and concluded that in the case before it, "a one-time agreement not to engage in certain activities" did not constitute "the kind of continuous and regular activity characteristic of a trade or business." *Id.* But Slaughter's noncompetition agreements were not one-time events — noncompetition clauses appeared in every American contract that she signed. Moreover, the clauses for the most part did not prevent Slaughter from writing for other publishers — they merely required her to complete the contracted books first. Consequently, we cannot say that the tax court erred in determining that Slaughter's income from her noncompetition agreements was derived from her trade or business.[415]

Thus, the panel sustained the Tax Court's finding that all her publishing income was self-employment income.

[414] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021
[415] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021

SECTION: 1411
SUPREME COURT RULES PLAINTIFFS DID NOT HAVE STANDING TO CHALLENGE AFFORDABLE CARE ACT, NET INVESTMENT INCOME TAX REMAINS IN FORCE

Citation: California *v.* Texas, US Supreme Court, Case No. 19-840, 6/17/21

When a US District Judge in Texas ruled in 2018 that the Affordable Care Act had been rendered retroactively unconstitutional in its entirety by the Tax Cuts and Jobs Act, a number of advisers rushed to file claims for refunds for years where clients had paid the net investment income tax under IRC §1411. The Supreme Court has now decided the fate of those refund claims, overturning the lower court decision in a 7-2 decision and keeping the entire Affordable Care Act in force.[416]

The case arose once Congress reduced the amount due under IRC §5000A for individuals who failed to maintain minimum essential coverage to zero in the Tax Cuts and Jobs Act. The plaintiffs argued that this change was fatal to the entire Affordable Care Act (which would include the net investment income tax under IRC §1411), as the Supreme Court, in an opinion authored by Justice Roberts, had found the mandate constitutional because it represented a tax on those who failed to obtain insurance rather than making a failure to maintain insurance illegal.

While the trial court had ruled this caused the entire law to be rendered invalid, the Fifth Circuit had sent the case back to the trial court to give reasons why the entire law, rather than just the mandate, had to be rendered invalid by this change.[417] However, before that decision came down the case was appealed to the U.S. Supreme Court who agreed to hear the case.

The opinion, authored by Justice Breyer, joined by Justices Sotomayor, Kagan, Kavanaugh and Barrett along with Chief Justice Roberts, begins by outlining the basic claim of the plaintiffs:

> As originally enacted in 2010, the Patient Protection and Affordable Care Act required most Americans to obtain minimum essential health insurance coverage. The Act also imposed a monetary penalty, scaled according to income, upon individuals who failed to do so. In 2017, Congress effectively nullified the penalty by setting its amount at $0.

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[416] *California v. Texas*, US Supreme Court, Case No. 19-840, June 17, 2021, https://www.supremecourt.gov/opinions/20pdf/19-840_6jfm.pdf (retrieved June 17, 2021)

[417] Brent Kendall and Jess Bravin, "Supreme Court Leaves Affordable Care Act Intact," *Wall Street Journal*, June 17, 2021 10:42 am ET, https://www.wsj.com/articles/supreme-court-leaves-affordable-care-act-intact-11623938948?mod=e2tw (retrieved June 17, 2021 08:10 am MST, subscription required)

> See Tax Cuts and Jobs Act of 2017, Pub. L. 115–97, §11081, 131 Stat. 2092 (codified in 26 U. S. C. §5000A(c)).
>
> Texas and 17 other States brought this lawsuit against the United States and federal officials. They were later joined by two individuals (Neill Hurley and John Nantz). The plaintiffs claim that without the penalty the Act's minimum essential coverage requirement is unconstitutional. Specifically, they say neither the Commerce Clause nor the Tax Clause (nor any other enumerated power) grants Congress the power to enact it. See U. S. Const., Art. I, §8. They also argue that the minimum essential coverage requirement is not severable from the rest of the Act. Hence, they believe the Act as a whole is invalid.[418]

Justice Breyer does not keep the reader in suspense, as the opinion immediately goes on to give the result the majority arrived at and what they did not decide:

> We do not reach these questions of the Act's validity, however, for Texas and the other plaintiffs in this suit lack the standing necessary to raise them.[419]

Essentially, the Court decided the case on a technicality—but one that may mean no party will be able to bring a case before the Court to decide the specific issues of constitutionality of the mandate or, if the mandate is unconstitutional, require the entire Affordable Care Act, including the Net Investment Income Tax, to be rendered retroactively invalid.

The opinion notes:

> The Constitution gives federal courts the power to adjudicate only genuine "Cases" and "Controversies." Art. III, §2. That power includes the requirement that litigants have standing. A plaintiff has standing only if he can "allege personal injury fairly traceable to the defendant's allegedly unlawful conduct and likely to be redressed by the requested relief." *DaimlerChrysler Corp. v. Cuno*, 547 U. S. 332, 342 (2006) (internal quotation marks omitted); see *also Lujan v. Defenders of Wildlife*, 504 U. S. 555, 560–561 (1992). Neither the individual nor the state plaintiffs have shown that the injury they will suffer or have suffered is "fairly traceable" to the "allegedly unlawful conduct" of which they complain.[420]

The opinion first looks at the two individual plaintiffs who complain about the requirement to maintain coverage that is provided in IRC §5000A. But the Court

[418] *California v. Texas*, US Supreme Court, Case No. 19-840, June 17, 2021
[419] *California v. Texas*, US Supreme Court, Case No. 19-840, June 17, 2021
[420] *California v. Texas*, US Supreme Court, Case No. 19-840, June 17, 2021

found that there's no harm to ignoring the requirement—and thus no real harm to the plaintiffs:

> Their problem lies in the fact that the statutory provision, while it tells them to obtain that coverage, has no means of enforcement. With the penalty zeroed out, the IRS can no longer seek a penalty from those who fail to comply. See 26 U. S. C. §5000A(g) (setting out IRS enforcement only of the taxpayer's failure to pay the penalty, not of the taxpayer's failure to maintain minimum essential coverage). Because of this, there is no possible Government action that is causally connected to the plaintiffs' injury—the costs of purchasing health insurance. Or to put the matter conversely, that injury is not "fairly traceable" to any "allegedly unlawful conduct" of which the plaintiffs complain. Allen v. Wright, 468 U. S. 737, 751 (1984). They have not pointed to any way in which the defendants, the Commissioner of Internal Revenue and the Secretary of Health and Human Services, will act to enforce §5000A(a). They have not shown how any other federal employees could do so either. In a word, they have not shown that any kind of Government action or conduct has caused or will cause the injury they attribute to §5000A(a).[421]

To put it simply, the individuals are stuck in a "Catch-22" for a challenge—without a penalty under IRC §5000A there's no way they can be harmed by the government for failing to comply with the toothless mandate. But their challenge is based on the lack of a tax after the TCJA changes and the importance the existence of that tax had on the validity of the law in the majority opinion in *National Federation of Independent Business v. Sebelius*, 567 U. S. 519 (2012).

The opinion also notes that the relief requested must be tied to that injury:

> To consider the matter from the point of view of another standing requirement, namely, redressability, makes clear that the statutory language alone is not sufficient. To determine whether an injury is redressable, a court will consider the relationship between "the judicial relief requested" and the "injury" suffered. *Allen*, 468 U. S., at 753, n. 19. The plaintiffs here sought injunctive relief and a declaratory judgment. The injunctive relief, however, concerned the Act's other provisions that they say are inseverable from the minimum essential coverage requirement. The relief they sought in respect to the only provision they attack as unconstitutional—the minimum essential coverage provision—is declaratory relief, namely, a judicial statement that the provision they attacked is unconstitutional. See App. 61–63 ("Count One: Declaratory Judgment That the Individual Mandate of the ACA Exceeds Congress's Article I Constitutional Enumerated

[421] *California v. Texas*, US Supreme Court, Case No. 19-840, June 17, 2021

> Powers" (boldface deleted)); 340 F. Supp. 3d, at 619 (granting declaratory judgment on count I as to §5000A(a)); 352 F. Supp. 3d, at 690 (severing and entering partial final judgment on count I).
>
> Remedies, however, ordinarily "operate with respect to specific parties." *Murphy v. National Collegiate Athletic Assn.*, 584 U. S. ___, ___ (2018) (THOMAS, J., concurring) (slip op., at 3) (internal quotation marks omitted). In the absence of any specific party, they do not simply operate "on legal rules in the abstract." *Ibid.* (internal quotation marks omitted); see also *Mellon*, 262 U. S., at 488 ("If a case for preventive relief be presented, the court enjoins, in effect, not the execution of the statute, but the acts of the official, the statute notwithstanding").[422]

The states fair no better for standing, as the Court continued to look at how the change to IRC §5000A (a statute that is unenforceable and is not being enforced) created damages to them:

> As with the individual plaintiffs, the States also have failed to show how this injury is directly traceable to any actual or possible unlawful Government conduct in enforcing §5000A(a). Cf. *Clapper v. Amnesty Int'l USA,* 568 U. S. 398, 414, n. 5 (2013) ("plaintiffs bear the burden of . . . showing that the defendant's *actual action* has caused the substantial risk of harm" (emphasis added)). That alone is enough to show that they, like the individual plaintiffs, lack Article III standing.[423]

Justice Thomas pens a concurring opinion where he argues that he agrees with the result based on the case presented by the parties, but does not foreclose a possible standing option for the states as proposed in the dissent authored by Justice Alito—but notes that the states did not argue for standing as Justice Alito proposed it, so it would not be appropriate to consider it in this case.[424]

We should expect the IRS to begin denying those claims for refund that were based on the hope that this case would have resulted in the retroactive repeal of the net investment income tax. And it appears advisers will not need to be concerned with filing additional protective claims unless some plaintiff can come up with damages that give rise to a standing to ask for relief tied to the changes made to IRC §5000A.

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422 *California v. Texas*, US Supreme Court, Case No. 19-840, June 17, 2021

423 *California v. Texas*, US Supreme Court, Case No. 19-840, June 17, 2021

424 Justice Thomas, Concurring Opinion, *California v. Texas*, US Supreme Court, Case No. 19-840, June 17, 2021

NOTES

Unit

7

Business Developments

LEARNING OBJECTIVES

When you have completed this unit, you will be able to

› **Use** information regarding ERC guidance to assist clients in preparing claims for refunds

› **Obtain** a general understanding of key business tax developments over the past year and apply them to specific taxpayer situations

SECTION: ERC
DO TAXPAYERS NEED TO AMEND FORMS 941 OR FORMS 941-X THAT ARE AT ODDS WITH NOTICE 2021-49?

Citation: Notice 2021-49, 9/2/21

I've been asked a few times since Notice 2021-49 was published by the IRS what should be done about already filed Forms 941 or 941-X where an employee retention credit was claimed on the return in question for wages the Notice indicates are ineligible to be used to claim that credit.

For those who aren't up to speed on this issue, that Notice provided that controlling interest holders based on direct ownership of an interest of an employer who had any living relative in the following list would not be paid qualifying wages for the ERC by the controlled employer:

- Brother or sister;
- Ancestors (such as parents, grandparents, etc.); or

- Lineal descendant (such as a child, grandchild, etc.).[425]

This guidance was pretty much identical to the analysis we posted on April 3, 2021.[426] That article was inspired by a Twitter thread that was initiated by Dan Chodan, CPA on February 15, 2021,[427] where the matter was subject to a long discussion along with some private discussions I had with others earlier in February looking at this whole IRC §51(i)(1) issue and how it impacts the various employee retention credits.

Now that the IRS has weighed in, the question arises about whether clients that had filed returns and claims at odds with this position should be advised to file amended returns, as well as what exposure advisers may have if they advised for an alternative position. This article looks at these issues.

Is There a Duty to Amend?

The issue of whether a taxpayer is required to amend is not really one that is amenable to a simple yes/no answer (at least not without being a bit misleading), but the practical answer is much closer to no than yes.

Fundamentally the analysis depends on two factors:

- Did the taxpayer file the original return or claim for refund after reasonably attempting to determine the proper treatment under the law? *or*

- Was the taxpayer's initial position a supportable position based on the authorities we had at that time, taking into account if the position was or was not disclosed on a Form 8275?

If the answer to either of these questions is yes, then the taxpayer should not face any risk of penalties should the IRS examine the return in question. Thus, filing an amended return would not serve to reduce the risk of facing penalties under IRC §6662(b)(1) for negligence or a disregard of the rules or regulations. Note that the substantial understatement penalty of IRC §6662(b)(2) only applies to income taxes. However, the standards that apply in those cases (substantial authority or reasonable basis) do still apply to preparer penalties under IRC §6694 for payroll tax returns.

Note that if the taxpayer's initial position is determined ultimately to be the correct position, despite the IRS Notice, then the answer to the second question is yes. While I clearly have serious doubts about that result in a real-world exam with any level of

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425 Notice 2021-49, IRC §§267(c), 152(d)(2)(A)-(H)

426 Ed Zollars, CPA, "Tax Advisers' Area 51 - Employee Retention Credit and Majority Shareholders," *Current Federal Developments* website, April 3, 2021, https://www.currentfederaltaxdevelopments.com/blog/2021/4/3/tax-advisers-area-51-employee-retention-credit-and-majority-shareholders

427 Dan Chodan, Twitter, February 6, 2021, https://twitter.com/danchodan/status/1358072787987017729?s=20

competence on the part of the examining agent, I'm not the party that would ultimately be making this ruling.

While the taxpayer does not have to amend, there are reasons why a taxpayer might want to do so. First, many taxpayers do not want to risk facing an IRS examination dispute in any form, considering not only the cost of representation in the exam but the time that it invariably takes the taxpayer away from the business in which he/she earns money. That second cost, even though no checks are written to pay it, often is more expensive than the first. And that ignores the stress the taxpayers will go through while facing the uncertainty of an exam.

Second, it eliminates the need to defend and then discover if the taxpayer will be able to persuade the ultimate decision maker in their case to remove the penalty, be that the agent, the agent's supervisor, the appellate conferee, a trial court judge, or a majority of the judges in an appellate setting. The deeper into the process the taxpayer must go before obtaining victory on the penalty issue, the more expensive the exam, in both representation fees and lost opportunity to earn money by paying attention to the business, it becomes.

Finally, while penalties may be off the table, interest will continue to run on the unpaid taxes. So there will at least be that cost to delaying recognizing the amount due should the IRS come calling before the statute expires.

Offsetting this is the possibility, or likely probability, that the return will never be examined. While the adviser cannot consider this when advising the client of whether a position can be taken, it is a valid topic to discuss once the adviser is comfortable that the original position was proper at the time the return was filed.

But, in the final analysis, your client is probably not "required" to amend the return in most cases so long as the initial filing was made in good faith after taking reasonable steps by the client to determine the proper tax result. Although that somewhat depends on what you or your client would see as a requirement.

Aside from paying additional interest during the time such tax remains unpaid if the client does not amend but the IRS later comes in assesses the tax, there are most likely no other consequences in the nature of a penalty. While some clients might see the additional interest as requiring the amended return, those that understand the time value of money may likely agree that there does not appear to be a severe consequence for not having filed an amended return.

But the client may still decide, reasonably, that the client wishes to have the amendment prepared and filed.

The Potential Conflict with the Adviser

Under IRC §6694(a), the adviser is subject to penalties for a return he/she is treated as a preparer of in relation to a position on a tax return where tax is assessed related to that position if the position is deemed unreasonable. The position is unreasonable unless there was (at the time the return is filed) or is (at the time of the exam) substantial authority for a position[428] or, if the position was disclosed at the time the return was filed, there was a reasonable basis for the position.[429] However, if the position relates to a tax shelter (as defined at IRC §6662(d)(2)(C)(ii)), the position is treated as unreasonable unless it was reasonable to believe the position was more than likely to be sustained on its merits if the position was challenged.[430]

The taxpayer does not face those standards and, in fact, the adviser must remember the taxpayer will escape penalties if the taxpayer, lacking the expertise personally to determine the proper tax treatment, in good faith relies on the advice of a tax professional that was given all information the taxpayer believed was necessary or was asked to provide by the professional, possesses the stated qualifications to be relied upon to give such advice and was engaged to provide such advice. Note that the taxpayer escapes penalties in these conditions *even if the advice is found to be erroneous, including failing to meet the substantial authority or reasonable basis standards* so long as the taxpayer had no reason to suspect the advice was deficient.

What should be obvious is that, while the taxpayer may no longer need to worry about the support for the position to avoid penalties, the same is not true for the adviser who both gave the original advice and is now representing the taxpayer facing an IRS challenge. This sets up a potential conflict of interest where the adviser has an incentive to have the client keep challenging the penalty based on factors other than reliance on the advice of the adviser/preparer, or to continue to challenge the underlying assessment despite the fact that, once penalties no longer apply to the taxpayer, it may be more cost-effective on an overall basis (including those costs of stress and distraction from the business) to pay the tax and penalty. Such a concession could leave the adviser to later have to defend against IRS preparer penalties at the professional's own expense.

An adviser must consider this conflict if the IRS begins an examination on the issue, as well as if it impacts the advisers' advice related to the impact of filing an amended tax return. The conflict between the interests of the taxpayer and the interests of the advisers may require having the client obtain a new adviser to deal with the IRS exam. Failure to do so may expose the adviser to a charge of having had an undisclosed conflict of interest in the examination engagement, something that can come back to haunt the adviser in a civil claim filed by the client against the adviser or a complaint filed against the adviser with a licensing agency.

Risks to the Adviser Aside from the IRS

Even if the IRS does not pursue preparer penalties (and, frankly, most often the agency will not do this except in egregious cases), there is still a level of risk to the preparer if

[428] IRC §6694(a)(2)(A)

[429] IRC §6694(a)(2)(B)

[430] IRC §6694(a)(2)(C)

the client is unhappy that he/she had to face an IRS examination. The client may decide to either file a civil court action for damages against the professional, or could file a complaint with the agency licensing the preparer.

The civil complaint would argue that the preparer breached their professional responsibility to the client by failing to properly appraise the taxpayer of the risk of an examination on the position and the time and costs involved that would be involved with such a challenge to the return. Note that the issuance of Notice 2021-49 likely has changed the calculus on the cost of any exam on this position, making it far less likely the IRS will accept that the law allows for an ERC on wages of the controlling shareholder who has at least one living relative, thus forcing the client to possibly have to take the matter to court before first obtaining any realistic possibility of carrying the issue.

Clients that may seem very much in favor of staking out an aggressive position when discussing options initially may not remember being so much in favor of taking risks when an actual exam notice arrives on their doorstep. The best way to deal with such lapses of memory on behalf of clients is to have documented, in writing, the advice given to the client and confirm in writing the fact the client was informed of the risks and that the client had decided to move forward despite any such risks.

However, sometimes advisers prefer to simply give clients "the answer" to a proper tax position rather than communicating the uncertainty inherent in a large number of more than trivial tax issues. Such confident assertions of what the rules are, especially when they result in a taxpayer-friendly tax result, often are initially seen by clients as demonstrating competence compared to having received nuanced answers. In such a case, the client may truly be blindsided by the exam and justifiably upset with the preparer, who will be painted as using such answers merely to assure clients didn't balk at paying for the preparer's work.

Some clients who are upset may realize that litigation is expensive, but still may want to extract a pound of flesh for being put in the position of facing an examination. In that case, the client may file a complaint with a licensing board. For CPAs, this normally would be the state Board of Accountancy that granted the CPA's license.

In most states, CPAs in tax practice are expected to follow the AICPA *Statements of Standards on Tax Services*. Specifically, AICPA *Statement of Standards on Tax Services* No. 1 requires a CPA to comply with the more stringent of the AICPA standards (a position has a reasonable basis 1 in 3 chance of success) or the taxing authority standards (substantial authority), or at least a reasonable basis for a position where the position is disclosed when:

- Recommending a tax return position,
- Preparing a tax return or

- Signing a tax return.[431]

If a CPA is unable to show that the proper level of support existed for the position taken or advised, the CPA will generally be either presumed to have violated or be deemed as having violated the ethical standards for a CPA in a tax engagement. Such a determination may lead to sanctions against the CPA by the state Board in question.

State Board investigations are often time-consuming for the CPA, very stressful, and take time away from time spent in the practice that leads to billable work.

A similar set of issues would face an enrolled agent (EA) with the taxpayer filing a complaint against the EA based on the similar provisions in Circular 230.[432]

Even if the client decides to go the civil claim route only and not file a complaint with the licensing agency, the plaintiff's counsel and experts will make much of the fact that the adviser failed to follow the rules he/she was required to follow.

What to Do?

So what is a tax adviser to do if the adviser was involved in the initial filing of a Form 941 or a Form 941-X that claimed employee retention credit on wages paid to a controlling interest holder or their spouse, and there were living relatives that, under the holding of Notice 2021-49, would have served to bar the employer from claiming the credit on those wages?

I would suggest that the adviser take the following steps:

- Determine what level of authority existed for the position claimed on the Form 941 or Form 941-X at the time it was filed, as well as what exists now that Notice 2021-49 has been released. While the substantial authority (or reasonable basis with disclosure) rule does not apply to the client for paying penalties, those standards will apply to the preparer for the purpose of preparer penalties under IRC §6694 and, most likely, under professional standards related to tax return preparation discussed earlier. Similarly, if the advice meets those standards, it's unlikely the IRS could prevail arguing that the taxpayer either was negligent or ignored rules and regulations, thus negating the imposition of an accuracy-related negligence penalty.

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431 AICPA Statement on Standards for Tax Services No. 1, *Tax Return Positions*, ¶5 and 9

432 While CPAs are covered by Circular 230's language, in *Ridgely v. Lew*, 55 F. Supp. 3d 89 (D.D.C. 2014) the United States District Court for the District of Columbia found that the IRS Office of Professional Responsibility did not have authority under the IRC to regulate the tax preparation activities of CPAs, as federal law granted the IRS only the right to regulate a CPA's practice before the IRS. However, EAs are a special category of individuals who do not automatically qualify to represent taxpayers by being licensed by their state as a CPA or an attorney. The law grants the IRS the authority to determine who may be part of that category and it appears the IRS believes that this authority gives the IRS the right to look at and regulate the conduct of individuals it licenses as enrolled agents in this area. The IRS announced shortly after the *Ridgely* case was decided that they would not seek to appeal the court's decision and no appeal was filed.

If the adviser finds that authority wanting upon further review, the adviser should likely consult their liability carrier and their own counsel on how to proceed.

- The client should be advised regarding the IRS release of Notice 2021-49 in the Internal Revenue Bulletin, outlining the IRS position on this issue. The client needs to be told that the IRS position is at odds with the position taken on the Form 941 or Form 941-X and the potential consequences that may arise from that, as well as the taxpayers' ability to file a Form 941-X to mitigate some of the consequences. This information is required to be provided under *AICPA Statements on Standards for Tax Services* No. 6 and under Circular 230 when an error exists on a return and is strongly advised if there is the potential the IRS may view this as an error given this new ruling. The client is to be offered the option to decide whether or not to amend the return(s) after considering these issues—that decision is the client's decision to make.

- If the adviser is going forward and dealing with future Forms 941 or 941-X, regardless of the client's decision on amending previously filed returns, the adviser will need to take Notice 2021-49 into consideration as an authority when determining for which positions there exists either substantial authority or a reasonable basis for these returns/claims prepared following the issuance of Notice 2021-49. The mere fact that the adviser signed a Form 941 or Form 941-X as preparer or advised a client to file such a form claiming these wages prior to the issuance of Notice 2021-49 does not automatically mean the adviser may continue to sign such a return or give such advice. It is strongly recommended that an adviser consider requiring the client to consent to attaching a Form 8275 disclosing taking a position contrary to Notice 2021-49 if the adviser is to sign the return or, if the adviser is merely advising the client but not preparing the form, advising the client to attach such a Form 8275 to the return. Doing so makes it nearly impossible for the IRS to prevail in attempting to assert a penalty on this issue, as the client did not appear to hide what he/she was doing from the IRS (though, honestly, the IRS may very well not read the form on the initial processing, which really creates the best of all worlds as they are still stuck with having been told what the taxpayer was doing).

If the adviser is planning to continue to sign returns claiming such wages or recommend clients take such positions on Forms 941 or 941-X they plan to file, the adviser should prepare a full analysis using authorities listed in Reg. §1.6662-4(d)(3)(iii) and an analysis under the full Reg. §1.6662-4(d) to determine if substantial authority exists. Generally substantial authority requires showing the following per Reg. §1.6662-4(d)(3)(i):

> There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in

> determining whether substantial authority exists. The weight of authorities is determined in light of the pertinent facts and circumstances in the manner prescribed by paragraph (d)(3)(ii) of this section. There may be substantial authority for more than one position with respect to the same item. Because the substantial authority standard is an objective standard, the taxpayer's belief that there is substantial authority for the tax treatment of an item is not relevant in determining whether there is substantial authority for that treatment.

The authorities that may be considered are found at Reg. §1.6662-4(d)(3)(iii):

> Except in cases described in paragraph (d)(3)(iv) of this section concerning written determinations, only the following are authority for purposes of determining whether there is substantial authority for the tax treatment of an item: applicable provisions of the Internal Revenue Code and other statutory provisions; proposed, temporary and final regulations construing such statutes; revenue rulings and revenue procedures; tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties; court cases; congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill's managers; General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book); private letter rulings and technical advice memoranda issued after October 31, 1976; actions on decisions and general counsel memoranda issued after March 12, 1981 (as well as general counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin); Internal Revenue Service information or press releases; and notices, announcements and other administrative pronouncements published by the Service in the Internal Revenue Bulletin.

The regulation goes on to tell the advisers what does not establish substantial authority (editorial documents such as articles, CPE course materials, tax research service commentary paragraphs, etc.) but how such documents can be used to help uncover authority.

> Conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals are not authority. The authorities underlying such expressions of opinion where applicable to the facts of a particular case, however, may give rise to substantial authority for the tax treatment of an item.

As well, you must check to see if any authority you are looking to rely upon has been later overridden per the regulation.

> Notwithstanding the preceding list of authorities, an authority does not continue to be an authority to the extent it is overruled or modified, implicitly or explicitly, by a body with the power to overrule or modify the earlier authority. In the case of court decisions, for example, a district court opinion on an issue is not an authority if overruled or reversed by the United States Court of Appeals for such district. However, a Tax Court opinion is not considered to be overruled or modified by a court of appeals to which a taxpayer does not have a right of appeal, unless the Tax Court adopts the holding of the court of appeals. Similarly, a private letter ruling is not authority if revoked or if inconsistent with a subsequent proposed regulation, revenue ruling or other administrative pronouncement published in the Internal Revenue Bulletin.

If you determine there is not substantial authority in support of this position,[433] then you must determine if the reasonable basis standard under Reg. §1.6662-3(b)(3) can be met. For reasonable basis, the regulation provides in general:

> Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim.

The regulation does provide a safe harbor of sorts that can be relied upon. The regulation provides:

> If a return position is reasonably based on one or more of the authorities set forth in section 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in section 1.6662-4(d)(2). (See section 1.6662-4(d)(3)(ii) for rules with respect to relevance, persuasiveness, subsequent developments, and use of a well- reasoned construction of an applicable statutory provision for purposes of the substantial understatement penalty.)

As a final attempt to avoid a penalty, the adviser could look to reasonable cause and good faith even if it is eventually determined there was no reasonable basis for the position.

433 To be clear, I have made it clear I did not believe that substantial authority existed for taking the employee retention credit on the wages of majority owners and spouses of the same with any living relatives even before Notice 2021-49 came out, but it is up to each professional to independently make this determination and accept the consequences of defending that position.

> In addition, the reasonable cause and good faith exception in section 1.6664-4 may provide relief from the penalty for negligence or disregard of rules or regulations, even if a return position does not satisfy the reasonable basis standard.

However, asserting this position could be a problem for the client, since the best defense under this is that the adviser's experience and background clearly rendered him/her as not capable of determining the proper answer to this matter, which could bring into question the issue of whether the client acted reasonably relying upon the adviser's advice on the matter.

SECTION: ERC
TAXPAYER GIVEN A SAFE HARBOR TO EXCLUDE PPP FORGIVENESS AND CERTAIN GRANT REVENUE FROM GROSS RECEIPTS WHEN DETERMINING ERC QUALIFICATION

Citation: Revenue Procedure 2021-33, 8/10/21

A question that had bothered many employers that had borrowed money under the Paycheck Protection Program (PPP) was whether forgiveness of that loan, although excluded from taxable income, was nevertheless part of receipts under §448(c) that would impact the calculation of whether there had been a reduction in revenue that could qualify a taxpayer to claim the employee retention credit (ERC).

The IRS's answer, in Revenue Procedure 2021-33,[434] is that, yes, it is included in gross receipts under IRC §448(c)—but if you want to exclude it consistently in your calculations of gross receipts under IRC §448(c) for ERC purposes *only*, the agency will accept that as well.

General Rule: §448(c) Gross Receipts Includes PPP Forgiveness and ERC-Coordinated Grants

The IRS Revenue Procedure contains a description of the law, including the exclusion of income for forgiveness of a PPP loan, as well as the exclusion from income of amounts received from a shuttered venue operator grant or a restaurant revitalization grant (the two referred to in this procedure as ERC-Coordinated Grants).[435]

The procedure then goes on to give us the IRS's view that these items would be gross receipts under IRC §448(c):

[434] Revenue Procedure 2021-33, August 10, 2021, https://www.irs.gov/pub/irs-drop/rp-21-33.pdf (retrieved August 10, 2021)
[435] Revenue Procedure 2021-33, Section 2

> Although the amount of forgiveness of a PPP Loan is not included in gross income, that forgiveness amount would be included in gross receipts under § 448(c) of the Code and § 1.448-1T(f)(2)(iv), or § 6033 of the Code and § 1.6033- 2(g)(4), as applicable. Similarly, the amount of an ERC-Coordinated Grant received by a taxpayer is not included in gross income, but the amount would be included in gross receipts.[436]

EXAMPLE—PPP FORGIVENESS COUNTS AS GROSS RECEIPTS

TN, Inc. received a PPP loan of $200,000 in 2020. TN, Inc. has determined that the loan forgiveness income was triggered for income tax purposes on June 15, 2021. For the second quarter of 2021, TN, Inc. had gross receipts, other than receipts from forgiveness, of $750,000. In the second quarter of 2019, TN, Inc. had gross receipts of $1,000,000. With PPP forgiveness included in gross receipts for the second quarter of 2021, TN, Inc.'s gross receipts for that quarter under IRC §448(c) are $950,000, or 95% of the gross receipts for the same quarter in 2019. Thus, the amount is not less than 80% of the same quarter in 2019.

Assuming TN, Inc. was not subject to a full or partial shutdown in the second quarter of 2021 and that there was not a 20% drop in gross receipts from the first quarter of 2021 as compared with the first quarter of 2019, the inclusion of the PPP forgiveness in gross receipts would deny TN, Inc. the ability to claim the ERC in the second quarter of 2021. As well, it also could deny TN, Inc. any ERC in the third quarter of 2021, since TN, Inc. could not rely on a 20% drop in gross receipts in the immediately prior quarter to qualify for the ERC in the third quarter of 2021.

Safe Harbor to Exclude PPP Forgiveness and ERC-Coordinated Grants from §448(c) Gross Receipts for ERC Qualification

The IRS determined that the agency will provide a safe harbor method allowing the consistent exclusion of PPP forgiveness and ERC-Coordinated Grant income from gross receipts solely for ERC qualification purposes. The agency explained its justification as follows:

> Section 2301(g) of the CARES Act and § 3134(h) of the Code set forth a coordination rule providing that the employee retention credit does not apply to so much of the qualified wages paid by an eligible employer as are taken into account as payroll costs in connection with forgiveness of a PPP Loan or, in the case of § 3134(h), an ERC-Coordinated Grant (relief programs). This rule demonstrates a congressional intent that an employer be able to participate in the relief programs and also claim the employee retention credit, provided that the same dollar of wages that are paid for or reimbursed with relief

[436] Revenue Procedure 2021-33, Section 3.01

> program funds may not be treated as qualified wages for purposes of the employee retention credit. Including the amount of the forgiveness of a PPP Loan or the amount of an ERC-Coordinated Grant in gross receipts for determining eligibility to claim the employee retention credit could frustrate this congressional intent.[437]

The justification explains the problem that seems to frustrate Congressional intent:

> Specifically, an employer that participated in one or more of the relief programs and that otherwise has the requisite percentage decline in gross receipts might be precluded from claiming an employee retention credit with respect to a calendar quarter in which there is the decline in gross receipts solely because its participation in the relief program resulted in a temporary increase in gross receipts within the meaning of the tax law.[438]

Thus, the Revenue Procedure provides:

> Accordingly, this revenue procedure provides a safe harbor that permits an employer to exclude the amount of the forgiveness of a PPP Loan and the amount of ERC-Coordinated Grants from the definition of gross receipts solely for the purpose of determining eligibility to claim the employee retention credit (safe harbor). An employer is not required to apply this safe harbor. This safe harbor does not permit the exclusion of the amount of forgiveness of a PPP Loan or the amount of ERC-Coordinated Grants from the definition of gross receipts under § 448(c) or § 6033 of the Code for any other Federal tax purpose.[439]

The Revenue Procedure explains the application of the safe harbor as follows:

> An employer may exclude the amount of the forgiveness of a PPP Loan and the amount of any ERC-Coordinated Grants from its gross receipts in determining eligibility to claim the employee retention credit for a calendar quarter if the employer consistently applies this safe harbor in determining eligibility to claim the employee retention credit. An employer consistently applies this safe harbor by (i) excluding the amount of the forgiveness of any PPP Loan and the amount of any ERC-Coordinated Grant from its gross receipts for each calendar quarter in which gross receipts for that calendar quarter are relevant to determining eligibility to claim the employee retention credit, and (ii) applying the safe harbor to all employers treated as a

[437] Revenue Procedure 2021-33, Section 3.02
[438] Revenue Procedure 2021-33, Section 3.02
[439] Revenue Procedure 2021-33, Section 3.02

> single employer under the employee retention credit aggregation rules.[440]

The election to exclude the PPP forgiveness from income is made by simply excluding the income consistently when determining eligibility for the employee retention credit:

> An employer elects to use the safe harbor by excluding the amount of the forgiveness of a PPP Loan and the amount of ERC-Coordinated Grants from its gross receipts when determining eligibility to claim the employee retention credit on its employment tax return or adjusted employment tax return for that calendar quarter or, for employers that file employment tax returns on an annual basis, for the year including the calendar quarter.[441]

EXAMPLE—ELECTION TO EXCLUDE PPP REVENUE FROM GROSS RECEIPTS

If TN, Inc. decides to elect the use of this Revenue Procedure, the company will now have gross receipts that are 75% of those in the same quarter in 2019 (750,000/1,000,000). Thus, TN, Inc. will qualify to claim the ERC in the second quarter of 2021 based on this decline.

As well, TN, Inc. will also automatically qualify to claim the ERC in the third quarter of 2021, since now the immediately preceding quarter had a greater than 20% decline in gross receipts.

If a taxpayer wishes to revoke this election after making it, the IRS allows this to be done via an amended payroll tax report:

> Subject to the rule in section 3.03 of this revenue procedure, an employer may revoke its safe harbor election by including the amount of the forgiveness of the PPP Loan or the amount of ERC-Coordinated Grants in its gross receipts when determining eligibility to claim the employee retention credit for a calendar quarter on its adjusted employment tax return for that calendar quarter or, for employers that file employment tax returns on an annual basis, for the year including the calendar quarter. Due to the consistency rule in section 3.03 of this revenue procedure, the employer must adjust all employment tax returns that are affected by the revocation of the safe harbor election.[442]

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[440] Revenue Procedure 2021-33, Section 3.03

[441] Revenue Procedure 2021-33, Section 3.04

[442] Revenue Procedure 2021-33, Section 3.05

SECTION: ERC
IRS RELEASES ADDITIONAL GUIDANCE ON THE ERC , AND IT'S NOT GOOD NEWS FOR MAJORITY SHAREHOLDERS

Citation: Notice 2021-49, 8/4/21

The IRS has published 34 pages of additional guidance[443] on the Employee Retention Credit (ERC), including the first guidance on the changes made for the 3rd and 4th quarter credits and the official IRS word on the related party issues raised by the references to IRC §§51(i)(1) and 267(c) we wrote about in April of 2021.[444]

In the case of the issues for §§51(i)(1) and 267(c), the IRS arrived at an identical conclusion to that expressed in our April article—wages paid to those with a controlling interest in the employer will not be eligible for the credit unless the controlling interest holder has no living relatives (or just very remote ones).

There are two major sections to the Notice, the first providing guidance on the changes made to the ERC for the 3rd and 4th quarter of 2021 and the second providing guidance on additional issues applicable to all versions of the ERC.

Guidance Applicable to Both the 2020 and 2021 Versions of the ERC

The Notice also contains guidance related to various issues that had not been addressed in the previous Notices. This guidance generally applies to all versions of the ERC.

Related Individuals

The most controversial portion of the Notice is likely to be the IRS analysis of the impact of the related party rules found in all versions of the ERC. The answer is not totally surprising—as discussed earlier, we had previously come to the same conclusion the IRS arrived at that the text referenced was unambiguous and would most often render the wages paid to a majority owner ineligible for the ERC. But the result is one that will greatly surprise many business owners and more than a few tax professionals.

The IRS decided to address two issues that had become the subject of discussion among tax professionals regarding the ERC:

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443 Notice 2021-49, August 4, 2021, https://www.irs.gov/pub/irs-drop/n-21-49.pdf (retrieved August 4, 2021)

444 Edward K. Zollars, CPA, "Tax Advisers' Area 51 - Employee Retention Credit and Majority Shareholders," *Current Federal Tax Developments* website, April 3, 2021,

- Are wages paid to a more than 50% owner of the value of a corporation eligible to be treated as qualified wages? (The answer will be no in the overwhelming majority of cases.)

- Are wages paid to the spouse of that same more than 50% owner eligible to be treated as qualified wages? (While it's easier for a spouse's wages to qualify for the ERC, it's still highly unlikely to work in the vast majority of real-world situations.)

The IRS began by analyzing the impact of the "rules similar to" IRC §51(i)(1) language in the various versions of the ERC:

> Section 2301(e) of the CARES Act and section 3134(e) of the Code provide, in relevant part, that rules similar to the rules of section 51(i)(1) of the Code apply. Section 51(i)(1) generally provides that wages paid to certain related individuals are not taken into account for purposes of the work opportunity credit. Specifically, section 51(i)(1) and Treas. Reg. § 1.51-1(e)(1) provide that wages are not taken into account with respect to an individual who bears any of the relationships described in section 152(d)(2)(A)-(H) of the Code to the following:
>
> (i) the taxpayer, or
>
> (ii) if the taxpayer is a corporation, to an individual who owns, directly or indirectly more than 50 percent in value of the outstanding stock of the corporation (majority owner of a corporation), or
>
> (iii) if the taxpayer is an entity other than a corporation, to any individual who owns, directly or indirectly, more than 50 percent of the capital and profits interests in the entity (majority owner of a noncorporate entity).[445]

The relationships that are in the group whose wages are not eligible for the credit are listed in the Notice:

> Initially, simply applying the rules of section 152(d)(2)(A)-(H) of the Code for purposes of the employee retention credit, before taking into consideration the attribution rules of section 267(c), the wages paid to employees with the following relationships to a majority owner of a corporation or of a partnership or other entity are not qualified wages:
>
> (A) A child or a descendant of a child.
>
> (B) A brother, sister, stepbrother, or stepsister.

[445] Notice 2021-49, Section IV.D

> (C) The father or mother, or an ancestor of either.
>
> (D) A stepfather or stepmother.
>
> (E) A niece or nephew.
>
> (F) An aunt or uncle.
>
> (G) A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.
>
> (H) An individual (other than a spouse, determined without regard to section 7703, of the taxpayer) who, for the taxable year of the taxpayer, has the same principal place of abode as the taxpayer and is a member of the taxpayer's household.[446]

Note

The inclusion of the member of the household in the above list in the Notice appears to be a drafting error. IRC §51(1)(i) only refers to "subparagraphs (A) through (G) of section 152(d)(2)" for the list of individuals whose wages cannot be used to claim a credit.

Since the Internal Revenue Code controls when it is at odds with IRS guidance, a credit would be allowed for wages paid to a person who was a member of the household of any direct or indirect majority interest holder unless that member of the household also has one of the relationships listed in (A)–(G) above.

But there is a complication—the reference to IRC §267(c) that was referred to:

> Section 51(i)(1)(A) includes a parenthetical at the end of the subparagraph stating that an individual's ownership is determined with the application of section 267(c) of the Code. The Treasury Department and the IRS have concluded that the section 267(c) ownership attribution rules apply for purposes of determining both an individual's ownership of stock of a corporation and an individual's capital and profits interests in a partnership or other entity, consistent with the language in Treas. Reg. § 1.51-1(e)(1)(iii) and section 51(i)(1)(A).[447]

As we are directed to determine ownership using the rules of IRC §267(c), the Notice describes those rules:

> Section 267(c) of the Code provides rules regarding the constructive ownership of stock for purposes of determining whether an individual

[446] Notice 2021-49, Section IV.D
[447] Notice 2021-49, Section IV.D

> is considered a majority owner of a corporation. 9 Section 267(c) sets forth the following rules to determine whether an individual has constructive ownership of stock of a corporation:
>
> (1) stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;
>
> (2) an individual is considered to own the stock owned, directly or indirectly, by or for the individual's family;
>
> (3) an individual owning (otherwise than by the application of (2)) any stock in a corporation is considered to own the stock owned, directly or indirectly, by or for his partner;
>
> (4) the family of an individual includes only his brothers and sisters (whether by the whole or half-blood), spouse, ancestors, and lineal descendants; and
>
> (5) stock constructively owned by a person by reason of the application of (1) will be treated, for the purpose of applying (1), (2), or (3), as actually owned by that person. Stock constructively owned by an individual by reason of the application of (2) or (3) will not be treated as owned by the individual to again apply either rule to reattribute and make another individual the constructive owner of the stock.[448]

The list of family members found at (4) will prove particularly vexing in this context, as the Notice will make clear. The relatives will end up being attributed ownership from the qualifying owner, and then the actual owner will end up in that family member's list of barred relationships:

> Applying the rules of sections 152(d)(2)(A)-(H) and 267(c) of the Code, a majority owner of a corporation is a related individual for purposes of the employee retention credit, whose wages are not qualified wages, if the majority owner has a brother or sister (whether by whole or half-blood), ancestor, or lineal descendant.[449]

Specifically, the problem is detailed as follows:

> That is, applying the constructive ownership rules of section 267(c), the direct majority owner's ownership of the corporation is attributed to each of the owner's family members with a relationship described in section 267(c)(4); further, because each of those family members is considered to own more than 50 percent of the stock of the

[448] Notice 2021-49, Section IV.D
[449] Notice 2021-49, Section IV.D

> corporation after applying section 267(c), the direct majority owner of the corporation would have a relationship as defined in section 152(d)(2)(A)-(H) to the family member who is a constructive majority owner. Therefore, the direct majority owner is a related individual for purposes of the employee retention credit.[450]

In a footnote, the IRS warns us that minority shareholders are not necessarily safe in this situation either, especially when the other shareholders are members of the same family:

> Depending on the facts, the application of the rules of sections 152(d)(2)(A)-(H) and 267(c) may also result in a minority owner of a corporation being a related individual for purposes of the employee retention credit. See, example 4.[451]

While a person's spouse is not listed as a barred relative under IRC §152(d)(2)(A)-(H), the in-law relative rules or those for a descendant will often trap the majority owner's spouse:

> The spouse of a majority owner is a related individual for purposes of the employee retention credit, whose wages are not qualified wages, if the majority owner has a family member who is a brother or sister (whether by whole or half-blood), ancestor, or lineal descendant (and thus is deemed to own the majority owner's shares under section 267(c) of the Code) and the spouse bears a relationship described in section 152(d)(2)(A)-(H) of the Code to the family member. For example, a direct majority owner's brother would be a constructive majority owner under section 267(c)(2) and (4) and the spouse of the direct majority owner would be considered a related individual to the constructive majority owner by virtue of the in-law relationship described in section 152(d)(2)(G).[452]

The IRS notes there is a (relatively rare) situation where the majority owner and/or spouse will not have an issue—if there are no living relatives on the list found in IRC §267(c)(4):

> In the event that the majority owner of a corporation has no brother or sister (whether by whole or half-blood), ancestor, or lineal descendant as defined in section 267(c)(4) of the Code, then neither the majority owner nor the spouse is a related individual within the meaning of section 51(i)(1) of the Code and the wages paid to the majority owner and/or the spouse are qualified wages for purposes of the employee

[450] Notice 2021-49, Section IV.D
[451] Notice 2021-49, Section IV.D, Footnote 10
[452] Notice 2021-49, Section IV.D

retention credit, assuming the other requirements for qualified wages are satisfied.[453]

This section concludes with a series of four examples illustrating the application of these rules.

EXAMPLE 1, NOTICE 2021-49, SECTION IV.D

Parent and Child Shareholders

Corporation A is owned 80 percent by Individual E and 20 percent by Individual F. Individual F is the child of Individual E. Corporation A is an eligible employer with respect to the first calendar quarter of 2021. Both Individual E and Individual F are employees of Corporation A. Pursuant to the attribution rules of section 267(c) of the Code, both Individual E and Individual F are treated as 100 percent owners of Corporation A. Individual E has the relationship to Individual F described in section 152(d)(2)(C) of the Code, and Individual F has the relationship to Individual E described in section 152(d)(2)(A). Accordingly, Corporation A may not treat as qualified wages any wages paid to either Individual E or Individual F because both Individual E and Individual F are each related individuals for purposes of the employee retention credit.

EXAMPLE 2, NOTICE 2021-49, SECTION IV.D

Child of Shareholder Not An Employee of the Business

Corporation B is owned 100 percent by Individual G. Individual H is the child of Individual G. Corporation B is an eligible employer with respect to the first calendar quarter of 2021. Individual G is an employee of Corporation B, but Individual H is not. Pursuant to the attribution rules of section 267(c) of the Code, Individual H is attributed 100 percent ownership of Corporation B, and both Individual G and Individual H are treated as 100 percent owners. Individual G has the relationship to Individual H described in section 152(d)(2)(C) of the Code. Accordingly, Corporation B may not treat as qualified wages any wages paid to Individual G because Individual G is a related individual for purposes of the employee retention credit.

EXAMPLE 3, NOTICE 2021-49, SECTION IV.D

No Living Relatives Exception

Corporation C is owned 100 percent by Individual J. Corporation C is an eligible employer with respect to the first calendar quarter of 2021. Individual J is married to Individual K, and they have no other family members as defined in section 267(c)(4) of the Code. Individual J and Individual K are both employees of Corporation C. Pursuant to the attribution rules of section 267(c), Individual K is attributed 100 percent ownership of Corporation A, and both Individual J and Individual K are treated as 100 percent owners. However, Individuals J and K do not have any of the relationships to each other described in section 152(d)(2)(A)-(H) of the Code. Accordingly, wages paid by Corporation C to Individual J and Individual K in the first calendar quarter of 2021 may be treated as qualified wages if the amounts satisfy the other requirements to be treated as qualified wages.

453 Notice 2021-49, Section IV.D

EXAMPLE 4, NOTICE 2021-49, SECTION IV.D

Minority Shareholders, All Related

Corporation D is owned 34 percent by Individual L, 33 percent by Individual M, and 33 percent by Individual N. Individual L, Individual M, and Individual N are siblings. Corporation D is an eligible employer with respect to the first calendar quarter of 2021. Individual L, Individual M, and Individual N are employees of Corporation D. Pursuant to the attribution rules of section 267(c) of the Code, Individual L, Individual M, and Individual N are treated as 100 percent owners. Individual L, Individual M, and Individual N have the relationship to each other described in section 152(d)(2)(B) of the Code. Accordingly, Corporation D may not treat as qualified wages any wages paid to Individual L, Individual M, or Individual N.

Timing of the Qualified Wages Deduction Disallowance

One real practical problem that many tax advisers ran into was determining when the reduction of deductible wages had to be taken into account for income tax purposes. Due to the major changes made to the ERC in December 2020, many employers are filing for refunds in 2021 for wages paid in 2020 and most are finding that the funds take substantial time to be received.

While many advisers may have been hoping the IRS would allow reducing the wage deduction in the year the refund is finally received, the IRS did not take that route in the Notice:

> Under section III.L. of Notice 2021-20, a reduction in the amount of the deduction allowed for qualified wages, including qualified health plan expenses, caused by receipt of the employee retention credit occurs for the tax year in which the qualified wages were paid or incurred. When a taxpayer claims the employee retention credit because of the retroactive amendment of section 2301 of the CARES Act by section 206(c) of the Relief Act (relating to eligibility of PPP borrowers to claim the employee retention credit) or otherwise files an adjusted employment tax return to claim the employee retention credit, the taxpayer should file an amended federal income tax return or administrative adjustment request (AAR), if applicable, for the taxable year in which the qualified wages were paid or incurred to correct any overstated deduction taken with respect to those same wages on the original federal tax return. Section 2301(e) generally provides, in relevant part, that rules similar to the rules of section 280C(a) of the Code shall apply. Section 280C(a) requires tracing to the specific wages generating the applicable credit. See, generally,

> Treas. Reg. § 1.280C-1. To satisfy this tracing requirement, the taxpayer must file an amended return or AAR, as applicable.[454]

Alternative Quarter Election for Calendar Year 2021 ERC Versions

Under both 2021 versions of the ERC, employers have a choice of testing either the current quarter or the immediately prior quarter for a 20% revenue reduction compared to the same quarter in 2019. If either of the testing quarters has the requisite reduction in revenue, then the employer can claim the ERC for the payroll quarter.

But if an employer used Quarter 1 of 2021's reduction in revenue to qualify for the ERC for the first quarter of 2021, is the employer barred from using that same first quarter decrease to qualify for the ERC in the second quarter? The IRS holds in the Notice that the taxpayer can still choose to look to either the prior or current quarter, regardless of what choice was made on the prior Form 941.

> As noted in section III.C. of Notice 2021-23, the determination of whether an employer is an eligible employer based on a decline in gross receipts is made separately for each calendar quarter. Thus, employers are not required to use the alternative quarter election consistently. For example, an employer may be an eligible employer due to a decline in gross receipts for the second quarter of 2021 if its gross receipts for the second quarter are equal to 75 percent of its gross receipts in the second quarter of 2019 (i.e., the employer does not rely on the alternative quarter election for the second quarter); the employer could then use the alternative quarter election to be an eligible employer for the third quarter of 2021.[455]

The practical effect of this means that if a taxpayer has a 20% drop in one quarter, the employer will automatically qualify for the ERC not just for the quarter with the drop in revenue, but also for the following quarter so long as the ERC has not expired prior to that following quarter.

Tips and the §45B Credit

The issue of how an employer is to treat tips for purposes of the ERC has been raised with the IRS, and the Notice seeks to clarify this issue:

> Section 3121(a)(12) of the Code excludes from the definition of "wages" tips paid in any medium other than cash and cash tips received by an employee in any calendar month in the course of employment by an employer unless the amount of the cash tips is $20 or more. Accordingly, if cash tips received by an employee in a calendar month amount to $20 or more, all of the cash tips received by

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[454] Notice 2021-49, Section IV.C

[455] Notice 2021-49, Section IV.E

> the employee in that calendar month are included in wages. Similarly, section 3231(e)(3) of the Code provides that the term "compensation" includes cash tips received by an employee in any calendar month in the course of employment by an employer unless the amount of such cash tips is less than $20. Under section 3121(q), tips received by an employee in the course of the employee's employment are considered remuneration for that employment (i.e., wages) and are deemed to have been paid by the employer for purposes of the taxes imposed by section 3111(a) and (b) of the Code. Thus, for purposes of chapters 21 and 22 of the Code, cash tips of $20 or more in a month are treated as wages paid by the employer.[456]

So long as the tips are treated as wages (that is, they are in cash and more than $20 in a calendar month), they will be qualified wages for the ERC so long as they otherwise qualify:

> Therefore, any cash tips treated as wages within the definition of section 3121(a) of the Code or compensation within the definition of section 3231(e)(3) of the Code are treated as qualified wages if all other requirements to treat the amounts as qualified wages are satisfied.[457]

The IRS Notice also provides that claiming the credit for certain tips under IRC §45B and the ERC on the same amounts is allowed:

> Section 2301 of the CARES Act and section 3134 of the Code cross-reference specific provisions in the Code, the CARES Act, the FFCRA, the Consolidated Appropriations Act, 2021, and the ARP that prevent the receipt of a double benefit with respect to wages for which the employee retention credit is claimed. Neither section 2301 nor section 3134 cross-references section 45B of the Code. Section 45B(c) denies a deduction under chapter 1 of the Code for any amount taken into account in determining the credit under section 45B; however, this provision does not prevent the receipt of both the employee retention credit and the section 45B credit for the same wages. Therefore, eligible employers are not prevented from receiving both the employee retention credit and the section 45B credit for the same wages.[458]

[456] Notice 2021-49, Section IV.B
[457] Notice 2021-49, Section IV.B
[458] Notice 2021-49, Section IV.B

Full-Time Employees and Full-Time Equivalents

The Notice clarifies the importance of full-time employees (as opposed to full-time equivalents) in applying the ERC rules:

> The Treasury Department and the IRS have been asked about the definition of "full-time employee" for the purpose of the employee retention credit, including (i) whether "full-time equivalents" (within the meaning of section 4980H(c)(2)(E) of the Code) are required to be included in the determination of whether an eligible employer is a large eligible employer or small eligible employer and (ii) whether wages paid to employees who are not full-time employees may be treated as qualified wages if all other requirements to treat the amounts as qualified wages are satisfied.[459]

The Notice reminds readers of the definition of a full-time employee for these purposes in a footnote:

> The term "full-time employee" means an employee who, with respect to any calendar month in 2019, had an average of at least 30 hours of service per week or 130 hours of service in the month (130 hours of service in a month is treated as the monthly equivalent of at least 30 hours of service per week), as determined in accordance with section 4980H of the Code. See Q/A-31 of Notice 2021-20 and section III.E. of Notice 2021-23.[460]

The Notice holds that for purposes of determining if an employer is a large or small employer, only full-time employees are considered:

> For purposes of determining whether an eligible employer is a large eligible employer or a small eligible employer, eligible employers are not required to include full-time equivalents when determining the average number of full-time employees.[461]

However, qualified wages are not limited to those paid to individuals who are full-time employees:

> However, for purposes of identifying qualified wages, an employee's status as a full-time employee is irrelevant, and wages paid to an employee who is not full-time may be treated as qualified wages if all other requirements to treat the amounts as qualified wages are satisfied.[462]

[459] Notice 2021-49, Section IV.A.
[460] Notice 2021-49, Section IV.A.
[461] Notice 2021-49, Section IV.A.
[462] Notice 2021-49, Section IV.A.

Continued Application of the Gross Receipts Safe Harbor in Notice 2021-20 Into 2021

A safe harbor the IRS introduced for employers that acquired another business in 2020 will also apply to employers who acquire a business in 2021:

> Section III.E. of Notice 2021-20 permits an employer that acquires a business in 2020 to include the gross receipts of the acquired business in its gross receipts for 2019 to determine whether the employer experienced a significant decline in gross receipts. The safe harbor allows the employer to include the gross receipts of the acquired business regardless of the fact that the employer did not own the acquired business during a calendar quarter in 2019. The Treasury Department and the IRS have been asked whether this rule continues to apply to employers that acquire businesses in 2021. This rule continues to apply to employers that acquire businesses in 2021 for purposes of measuring whether a decline in gross receipts occurred.[463]

Similarly, the rule dealing with businesses that came into existence during the middle of a calendar quarter in 2019 found in Notice 2021-20 will apply to businesses that came into existence in 2020:

> The Treasury Department and the IRS have also been asked how to calculate gross receipts of employers that came into existence in the middle of a calendar quarter in 2020. Section III.E. of Notice 2021-20 provides rules for determining gross receipts for an employer that came into existence in 2019. The same rule set forth in section III.E. of Notice 2021-20 continues to apply for 2021. For example, an employer that came into existence in the third quarter of 2020 should use that quarter as the base period to determine whether it experienced a significant decline in gross receipts for the first three quarters in 2021 and should use the fourth quarter of 2020 for comparison to the fourth quarter of 2021 to determine whether it experienced a significant decline in gross receipts.[464]

Changes Made Related to the Credit for the Last Six Months of 2021 (IRC §3134)

The first section of the guidance discusses the changes in the ERC that apply for the last six months of 2021.[465]

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[463] Notice 2021-49, Section IV.F

[464] Notice 2021-49, Section IV.F

[465] At the time this was written , Congress was considering bipartisan infrastructure legislation that would get a portion of the funds to pay for the additional spending by repealing this credit for the 4th quarter of 2021 except for recovery startup businesses.

Change in Applicable Employment Taxes Offset First by Credit

For reasons having to do with the trust fund tax penalties and other accounting issues, the ERC has always been used in the following order:

- First, to reduce the employer's share of certain payroll taxes imposed on the employer (but not those withheld from the employee) and then
- Second, any remaining balance is treated as refunded to the taxpayer, though the IRS has very reasonably allowed this refund to first be offset against the payroll tax deposits remaining due when the credit is claimed.[466]

For purposes of the credit from its inception in March 2020 through June 30, 2021, the credit was first used to offset the following employer payroll taxes:

> For purposes of the employee retention credit under the CARES Act, section 2301(c)(1) defines "applicable employment taxes" to mean the taxes imposed on employers by section 3111(a) of the Code (employer's share of the Old Age, Survivors, and Disability Insurance (social security tax)), or so much of the taxes imposed on employers by section 3221(a) of the Code (Tier 1 tax under the Railroad Retirement Tax Act (RRTA)) that are attributable to the rate in effect under section 3111(a). Section II.A. of Notice 2021-20 provides that, under section 2301, eligible employers are entitled to claim the employee retention credit against the employer's share of social security tax after these taxes are reduced by any credits claimed under sections 3111(e) and (f), sections 7001 and 7003 of the Families First Coronavirus Response Act (FFCRA), Pub. L. No. 116-127, 134 Stat. 178 (2020), and section 303(d) of the Relief Act. Section II.A. of Notice 2021-20 further provides that, under section 2301, eligible employers subject to the RRTA are entitled to claim the employee retention credit against the portion of Tier 1 tax under the RRTA that is equivalent to the employer's share of social security tax after these taxes are reduced by any credits allowed under sections 7001 and 7003 of the FFCRA and section 303(d) of the Relief Act.[467]

The Notice points out that, beginning with the wages paid in June 2021, the taxes to be offset switch from the employer share of FICA (and the equivalent RRTA tax) to the Medicare taxes imposed on the employer:

> For purposes of the employee retention credit under section 3134 of the Code, section 3134(c)(1) defines "applicable employment taxes" to mean the taxes imposed under section 3111(b) of the Code (employer's share of Hospital Insurance (Medicare) tax), or so much of

[466] CARES Act Section 2301 and IRC §3134
[467] Notice 2021-49, Section III.B.

> the portion of Tier 1 tax under the RRTA that is equivalent to the employer's share of Medicare tax. Section 3134(b)(2) provides that the credit allowed under section 3134(a) with respect to a calendar quarter will not exceed the applicable employment taxes, reduced by any credits allowed under sections 3131 and 3132 of the Code (tax credits under the ARP for qualified sick leave wages and qualified family leave wages, respectively, paid with respect to leave taken by employees beginning on April 1, 2021, through September 30, 2021), on the wages paid with respect to the employment of all the employees of the eligible employer for such calendar quarter. Section 3134(b)(3) provides that if any amount of the credit under section 3134(a) exceeds the limitation under section 3134(b)(2) for any calendar quarter, such excess will be treated as an overpayment that will be refunded under sections 6402(a) and 6413(b) of the Code.
>
> Accordingly, for the third and fourth quarters of 2021, eligible employers are entitled to claim the employee retention credit against the employer's share of Medicare tax, or the portion of Tier 1 tax under the RRTA that is equivalent to the employer's share of Medicare tax, after these taxes are reduced by any credits allowed under sections 3131 and 3132 of the Code, with the excess refunded under section 6402 or 6413 of the Code.[468]

For employers, this will result in a change in the mechanics of reporting the credit on the Form 941 (the nonrefundable portion will offset employer Medicare, rather than social security, taxes), but not the ultimate result of effectively applying the credit against total payroll taxes withheld and imposed on the employer for the quarter.

Limits on the Amount of the Credit

The Notice notes that while the maximum credit rules remain the same as for the ERC credit for the first two quarters of 2021 (70% of qualified wages and health plan expenses with a limit of total costs counted of $10,000 per employee per quarter) for most employers, there is a new limit for recovery start-up businesses, discussed next.[469]

Recovery Startup Businesses

The Notice discusses the new category of "recovery startup businesses" eligible for the ERC in the third and fourth quarters of 2021.

The Notice begins with a broad discussion of the definition of a *recovery startup business* along with a summary of the special rules that apply to such businesses:

[468] Notice 2021-49, Section III.B.

[469] Notice 2021-49, Section III.C

> Section 3134(c)(5) of the Code defines a "recovery startup business" as an employer (i) that began carrying on any trade or business after February 15, 2020, (ii) for which the average annual gross receipts of the employer (as determined under rules similar to the rules under section 448(c)(3) of the Code) for the 3-taxable-year period ending with the taxable year that precedes the calendar quarter for which the credit is determined does not exceed $1,000,000, and (iii) that is not otherwise an eligible employer due to a full or partial suspension of operations or a decline in gross receipts. Section 3134(b)(1)(B) provides that in the case of an eligible employer that is a recovery startup business, the amount of the credit allowed under subsection 3134(a) (after application of the limit under subsection 3134(b)(1)(A)) for each of the third and fourth calendar quarters of 2021 cannot exceed $50,000.[470]

The Notice moves on to the issue of how to determine the date when a taxpayer begins carrying on a trade or business:

> Section III.A. of Notice 2021-20 provides that for purposes of the employee retention credit, "trade or business" has the same meaning as when used in section 162 of the Code other than the trade or business of performing services as an employee. Section 3134(c)(5)(A) of the Code provides that a recovery startup business is an employer that began carrying on a trade or business after February 15, 2020. Therefore, the determination of when an employer "began carrying on a trade or business" is made in the same manner as for purposes of section 162. In general, for purposes of section 162, a taxpayer has not begun carrying on a trade or business "until such time as the business has begun to function as a going concern and performed those activities for which it was organized." *Richmond Television Corp. v. U.S.*, 345 F.2d 901, 907 (4th Cir. 1965), *vacated and remanded on other grounds per curiam*, 382 U.S. 68 (1965), *on remand*, 354 F.2d 410 (4th Cir. 1965), *overruled on other grounds*; *NCNB Corporation v. United States*, 684 F.2d 285 (4th Cir. 1982); see also Rev. Rul. 81-150, 1981-1 C.B. 119.[471]

The Notice points out the revenue limits that apply to such businesses and the time period in question:

> Section 3134(c)(5) of the Code indicates that the average annual gross receipts of an employer is determined by applying rules similar to the rules in section 448(c)(3) of the Code and that the 3-taxable-year

[470] Notice 2021-49, Section III.D.
[471] Notice 2021-49, Section III.D.

> period ends with the taxable year preceding the calendar quarter for which the employer is claiming the employee retention credit.[472]

The Notice continues on to provide guidance on applying the recovery startup business rules to an exempt organization under IRC §501(c).

> Section III.A. of Notice 2021-20 states that, for purposes of the employee retention credit, a tax-exempt organization described in section 501(c) of the Code that is exempt from tax under section 501(a) is deemed to be engaged in a "trade or business" with respect to all operations of the organization, as provided in section 2301(c)(2)(C) of the CARES Act. Similar to the rule in section 2301(c)(2)(C), section 3134(c)(2)(C)(i) provides that, in the case of an organization described in section 501(c) and exempt from tax under section 501(a), the requirement in section 3134(c)(2)(A)(i) of carrying on a trade or business to be an eligible employer and the requirement in section 3134(c)(2)(A)(ii)(I) that a trade or business has been fully or partially suspended due to an appropriate governmental order to be an eligible employer apply to all operations of the organization. Section 3134(c)(2)(C)(ii) further provides that, in the case of a tax-exempt organization, any reference to gross receipts will be treated as a reference to gross receipts within the meaning of section 6033 of the Code. While section 3134(c)(2)(C)(i) does not specifically reference the trade or business requirement in the definition of a recovery startup business in section 3134(c)(5)(A), because of the broad language in section 3134(c)(2)(C)(ii) for measuring gross receipts and the other language in section 3134(c)(2)(C)(i) indicating an intent by Congress to fully include tax-exempt organizations within the three categories of an eligible employer, the Treasury Department and the IRS have determined that it is appropriate for an organization described in section 501(c) and exempt from tax under section 501(a) to be able to be treated as an eligible employer due to being a recovery startup business based on all of its operations and average annual gross receipts determined under section 6033 as defined in section III.E. of Notice 2021-20.[473]

The Notice also indicates that, despite Congress failing to update the definition of *qualified wages* to include wages paid by a recovery startup business, the IRS will treat such wages as qualified wages:

> The Treasury Department and the IRS have also determined that it is appropriate for the term "qualified wages" to include wages paid by a recovery startup business. The definition of "qualified wages" in section 3134(c)(3)(A) of the Code is identical to the definition in

[472] Notice 2021-49, Section III.D.
[473] Notice 2021-49, Section III.D.

> section 2301(c)(3)(A) of the CARES Act. Section 3134(c)(3)(A)(i), the large eligible employer rule, defines qualified wages as wages paid with respect to which an employee is not providing services due to circumstances described in section 3134(c)(2)(A)(ii)(I) (relating to a full or partial suspension) or section 3134(c)(2)(A)(ii)(II) (relating to a decline in gross receipts). Section 3134(c)(3)(A)(ii), the small eligible employer rule, defines qualified wages as wages paid during any period described in section 3134(c)(2)(A)(ii)(I) (relating to a full or partial suspension) or paid with respect to any employee during a quarter described in section 3134(c)(2)(A)(ii)(II) (relating to a decline in gross receipts). Neither the large eligible employer rule in section 3134(c)(3)(A)(i) nor the small eligible employer rule in section 3134(c)(3)(A)(ii) was updated to include section 3134(c)(2)(A)(ii)(III) (relating to a recovery startup business). Thus, the language of the statute does not include a definition of qualified wages applicable to a recovery startup business. However, the inclusion of recovery startup businesses as a new category of eligible employer and the provision of a specific limitation on the amount of the employee retention credit to which recovery startup businesses are entitled indicates that Congress intended that this new category of eligible employer be able to claim the employee retention credit. In order to carry out this intent, the Treasury Department and the IRS have concluded that it is appropriate to read the small eligible employer rule in section 3134(c)(3)(A)(ii)(II) as if section 3134(c)(2)(A)(ii)(III) were included after the reference to section 3134(c)(2)(A)(ii)(II). Accordingly, in the third and fourth calendar quarters of 2021, a recovery startup business that is a small eligible employer within the meaning of section 3134(c)(3)(A)(ii) may treat all wages paid with respect to an employee during the quarter as qualified wages.[474]

An employer tests whether it is a recovery startup business on a quarter-by-quarter basis per the Notice:

> The determination of whether an employer is a recovery startup business is made separately for each calendar quarter. For example, if an eligible employer is a recovery startup business in the third quarter of 2021 but is not a recovery startup business in the fourth quarter of 2021 because it is an eligible employer due to a full or partial suspension or a decline in gross receipts during the fourth quarter of 2021, the $50,000 limitation applies to the third quarter of 2021 but does not apply to the fourth quarter of 2021.[475]

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[474] Notice 2021-49, Section III.D.
[475] Notice 2021-49, Section III.D.

The Notice also provides that the aggregation rules discussed in Notice 2021-20 will apply for determining if a business is a recovery startup business:

> The aggregation rules described in section III.B. of Notice 2021-20 apply when determining whether an employer's trade or business is fully or partially suspended or the employer experiences a decline in gross receipts. Similarly, the aggregation rules described in section III.B. of Notice 2021-20 apply when determining if an employer is a recovery startup business. The aggregation rules also apply with respect to the $50,000 limitation on the credit.[476]

Qualified Wages

The Notice goes on to discuss the changes to qualified wages that apply for the 3rd and 4th quarter ERC. While these changes won't affect most employers, they will allow some employers to claim the credit or qualify for an increased credit as compared to the prior qualified wage rules.

The Notice first discusses the special rules added for employers not in existence during 2019:

> Section 3134(c)(3)(A) of the Code defines the term "qualified wages" and provides the distinction in treatment between large eligible employers and small eligible employers. Section 3134(c)(3)(B) provides that in the case of any employer that was not in existence in 2019, section 3134(c)(3)(A) is applied by substituting "2020" for "2019" each place it appears and requires eligible employers not in existence in 2019 to determine the average number of full-time employees in 2020 instead of 2019. Section III.G. of Notice 2021-20 provides rules for determining the average number of full-time employees, including for employers that came into existence in 2020. Accordingly, the rules set forth in section III.G. of Notice 2021-20 for determining the average number of full-time employees continue to apply in the third and fourth calendar quarters of 2021.[477]

The Notice also discusses the new category of *severely financially distressed employers,* which enables certain employers that would normally be limited to claiming the credit only for employees that were not performing services to claim the credit regardless of whether the employee performed services:

> Section 3134(c)(3)(C) of the Code provides a different rule for qualified wages paid by "severely financially distressed employers." Section 3134(c)(3)(C)(ii) defines a "severely financially distressed employer" as an employer that is an eligible employer based on a

476 Notice 2021-49, Section III.D.

477 Notice 2021-49, Section III.E.

> decline in gross receipts, but the gross receipts for the eligible employer for the calendar quarter are less than 10 percent of the gross receipts as compared to the same calendar quarter in calendar year 2019, instead of less than 80 percent.
>
> Accordingly, for purposes of the employee retention credit for the third and fourth calendar quarters of 2021, an eligible employer with gross receipts that are less than 10 percent of the gross receipts for the same calendar quarter in calendar year 2019 (or 2020, if the employer was not in existence in 2019) is a severely financially distressed employer.[478]

The Notice goes on to outline how an employer determines if it has a qualifying decline in gross receipts for purposes of qualifying as a *severely financially distressed employer*:

> The rules for how an employer determines whether it has experienced a decline in gross receipts for purposes of the employee retention credit are set forth in section III.C. of Notice 2021-23. Whether an employer has met the decline in gross receipts test generally is determined by comparing the quarter in 2020 or 2021 to the same quarter in 2019. Notice 2021-23 also provides rules that address the circumstance in which the employer was not in existence as of the beginning of a calendar quarter in 2019 and rules for how an employer may elect to use an alternative quarter to determine whether it has experienced a decline in gross receipts. These rules that apply for purposes of determining whether an employer is an eligible employer based on a decline in gross receipts also apply, in the third and fourth calendar quarters of 2021, for purposes of determining whether an eligible employer is a severely financially distressed employer based on the 10 percent threshold. For example, an eligible employer that has gross receipts of 5 percent in the second quarter of 2021 compared to gross receipts in the second quarter of 2019 is a severely financially distressed employer for the third quarter of 2021 based on the alternative quarter election.[479]

In a footnote, the IRS also addresses an ambiguity in the law regarding *when* the qualifying wages need to be paid for a severely financially distressed employer:

> The language of section 3134(c)(3)(C)(i) of the Code is ambiguous as to the calendar quarter in which wages paid by a severely financially distressed employer may be treated as qualified wages. Due to the reference to section 3134(c)(3)(A)(i) of the Code, however, the Treasury Department and the IRS have determined that Congress intended section 3134(c)(3)(C)(i) to extend the small eligible employer

[478] Notice 2021-49, Section III.E.
[479] Notice 2021-49, Section III.E.

> rule to a severely financially distressed employer that is also a large eligible employer, and not to change the timing of when qualified wages are paid for purposes of claiming the employee retention credit. Therefore, a severely financially distressed employer may claim the employee retention credit only with respect to qualified wages the employer paid in the same calendar quarter in which it is claiming the credit.[480]

The Notice provides the following example of the financially distressed employer rules in action:

EXAMPLE, NOTICE 2021-49, SECTION III.D.

Employer A is a large eligible employer with gross receipts in the third quarter of 2021 equal to 15 percent of its gross receipts in the third quarter of 2019. Employer A is not a severely financially distressed employer for the third quarter of 2021 based on the third quarter's gross receipts. However, Employer A's gross receipts in the second quarter of 2021 are less than 10 percent of its gross receipts in the second quarter of 2019; therefore, Employer A may elect to use the alternative election rule to meet the definition of a severely financially distressed employer under section 3134(c)(3)(C)(ii) of the Code in the third quarter of 2021.

In the third quarter of 2021, Employer A pays Employee B $10,000 in wages for services Employee B provided during the third quarter. Employer A may claim the employee retention credit in the third quarter of 2021 (the quarter in which Employer A is determined to be severely financially distressed under the alternative election rule) and may treat all of the wages paid to Employee B during the third quarter of 2021 as qualified wages.

In the fourth quarter of 2021, Employer A's gross receipts equal 20 percent of its gross receipts in the fourth quarter of 2019. Employer A is not a severely financially distressed employer for the fourth quarter of 2021 based on the fourth quarter's gross receipts. In addition, Employer A cannot use the alternative election rule in the fourth quarter of 2021 to qualify as a severely distressed employer because Employer A's gross receipts in the third quarter of 2021 are not less than 10 percent of its gross receipts in 2019; therefore, Employer A is not a severely financially distressed employer (though it is still an eligible employer) in the fourth quarter of 2021.

Employer A pays Employee B $10,000 in wages in the fourth quarter of 2021 for services Employee B provided during the fourth quarter of 2021. Employer A may not treat any of the wages paid to Employee B for services provided during the fourth quarter as qualified wages because Employer A is a large eligible employer and does not meet the definition of a severely financially distressed employer for the fourth quarter of 2021.

Coordination with Certain Tax Credits and Programs

The 3rd and 4th quarter ERC has somewhat modified rules for coordination with certain tax credits and other federal programs.

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480 Notice 2021-49, Section III.E., Footnote 4

The Notice explains the rule that applies with regard to wages taken into consideration for certain tax credits:

> Section 3134(c)(3)(D) of the Code provides that for the third and fourth calendar quarters of 2021, the term "qualified wages" does not include any wages taken into account under sections 41, 45A, 45P, 45S, 51, 1396, 3131, and 3132 of the Code. That is, if wages are taken into account for purposes of those sections, those wages cannot be taken into account for purposes of the employee retention credit.[481]

A footnote explains how this differs from the prior versions of the ERC:

> These Code sections, with the exception of sections 3131 and 3132, were included in the denial of double benefit provisions for the first and second calendar quarters of 2021 and applied in the inverse order, meaning that any wages taken into account as qualified wages for the employee retention credit could not be taken into account for those sections. See section III.E. of Notice 2021-23.[482]

Wages taken into account under various federal relief programs are also removed from qualified wages for purposes of the 3rd and 4th quarter ERC. The Notice begins by holding that the same rules provided in Notice 2021-20 will continue to apply for wages used to apply for forgiveness for Paycheck Protection Program loans.

> Section III.I. of Notice 2021-20 provides rules related to the interaction between PPP loans and the employee retention credit; under those rules, the employee retention credit does not apply to the qualified wages for which an election or deemed election to not take the wages into account for purposes of the credit is made. These rules are derived from section 2301(g)(1) and (g)(2) of the CARES Act, as amended by the Relief Act. Section 3134(g) of the Code retains the same language as section 2301(g)(1) of the CARES Act and section 3134(h)(1) and (h)(2) is similar in operation to section 2301(g)(1) and (g)(2); accordingly, the rules related to the interaction between PPP loans and the employee retention credit under section III.I. of Notice 2021-20 continue to apply in the third and fourth calendar quarters of 2021. Thus, the determination of whether section 3134 applies to amounts of qualified wages taken into account as payroll costs for PPP loans for purposes of section 3134(h)(1)(A) and (h)(2) are made in the same manner and under the same principles as prescribed in section III.I. of Notice 2021-20.[483]

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[481] Notice 2021-49, Section III.E (It appears that this discussion should have been in the next section, but in the original published Notice this discussion comes immediately after the discussion of the severely financially distressed employer rules.)

[482] Notice 2021-49, Section III.E., Footnote 6

[483] Notice 2021-49, Section III.F.

The Notice outlines the similar rules that apply to employers who obtained a restaurant revitalization grant or a shuttered venue operators grant.

> The shuttered venue operators grant was established by section 324 of the Economic Aid to Hard-Hit Small Businesses, Non-Profits, and Venues Act and amended by the ARP. The restaurant revitalization grant was established by the ARP. Coordination between the employee retention credit and these grants is not required under section 2301 of the CARES Act, which governs the employee retention credit for 2020 and the first two quarters of 2021. However, pursuant to section 3134(h)(1)(B) and (C) of the Code, an eligible employer receiving a shuttered venue operators grant or restaurant revitalization grant may not treat any amounts reported to the Small Business Administration (SBA) or otherwise taken into account as payroll costs in connection with either program as qualified wages for purposes of the employee retention credit in the third and fourth quarters of 2021. An eligible employer receiving a shuttered venue operators grant or restaurant revitalization grant must retain in its records support for the employee retention credit claimed, which includes any documentation supporting that the eligible employer did not claim the employee retention credit on amounts taken into account as payroll costs paid in the third and fourth quarters of 2021 in connection with the shuttered venue operators grant or restaurant revitalization grant programs.[484]

Extended Statute of Limitations on 3rd and 4th Quarter ERC

The Notice points out that there is an extended five-year statute of limitations on the IRS assessing an amount attributable to a 3rd or 4th quarter ERC that does not apply to the earlier versions of the credit:

> Section 3134(l) of the Code extends the limitation on assessment. Section 3134(l) provides that, notwithstanding section 6501 of the Code, the limitation on the time period for the assessment of any amount attributable to a credit claimed under section 3134 will not expire before the date that is 5 years after the later of (i) the date on which the original return that includes the calendar quarter with respect to which the credit is determined is filed, or (ii) the date on which the return is treated as filed under section 6501(b)(2). The extension of limitation on assessment applies to the employee retention credit claimed for the third and fourth calendar quarters of 2021 under section 3134 but does not apply to the employee retention credit under section 2301 of the CARES Act.[485]

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[484] Notice 2021-49, Section III.F.

[485] Notice 2021-49, Section III.G.

SECTION: ERC UPDATED GUIDANCE ISSUED FOR EMPLOYEE RETENTION TO APPLY TO PROGRAM VERSION THAT RUNS FROM JANUARY TO JUNE 2021

Citation: Notice 2021-23, 4/2/21

The IRS released guidance on the version of the Employee Retention Credit (ERC) contained in the Taxpayer Certainty and Disaster Relief Act (TCDRA) of 2020 that is in effect for the first two quarters of 2021 in Notice 2021-23.[486]

As with Notice 2021-20, which was issued to cover the revised 2020 Employee Retention Credit, this Notice only updates the original Notice for issues related to the January-June 2021 version of the credit, and later guidance will be released governing new IRC §3134 that was added by the American Rescue Plan Act of 2021 and will apply from July-December 2021.

Expansion to Certain Governmental Entities

While the original ERC was not available to governmental entities, the TCDRA version created a limited exception:

> …[A]mended section 2301(f)(2)(A) provides an exception for any organization described in section 501(c)(1) of the Code and exempt from tax under section 501(a) of the Code, and amended section 2301(f)(2)(B) provides an exception for any governmental entity if the entity is a college or university or the principal purpose or function of the entity is providing medical or hospital care. The flush language of amended section 2301(f)(2) provides that in the case of any governmental entity that is a college or university, or the principal purpose or function of which is providing medical or hospital care, the entity shall be treated as satisfying the trade or business requirement in section 2301(c)(2)(A)(i). Accordingly, these entities may be eligible employers for the first and second calendar quarters of 2021, assuming they satisfy the other requirements to be eligible employers.[487]

The Notice provides definitions of a college and university and an entity with the principal purpose or function of providing health care:

> The Treasury Department and the IRS have determined that, for purposes of amended section 2301(f)(2)(B) of the CARES Act, a college or university means an educational organization as defined in

[486] Notice 2021-23, April 2, 2021, https://www.irs.gov/pub/irs-drop/n-21-23.pdf (retrieved April 2, 2021)
[487] Notice 2021-23, Section III.B

section 170(b)(1)(A)(ii) of the Code and Treas. Reg. § 1.170A-9(c)(1) that is a college or university, and an entity that has the principal purpose or function of providing medical or hospital care means an entity that has the principal purpose or function of providing medical or hospital care within the meaning of section 170(b)(1)(A)(iii) of the Code and Treas. Reg. § 1.170A-9(d)(1).[488]

Prior Quarter Election for Decline in Gross Receipts Test

Under the TCDRA version of the ERC, a new election was added to allow an employer to choose to use either the current quarter or the immediately prior one to test for a decline in gross receipts. The Notice provides specific guidance for the first and second quarters of 2021 on this issue:

> Accordingly, for the first calendar quarter of 2021, an employer may elect to use its gross receipts for the fourth calendar quarter of 2020 compared to those for the fourth calendar quarter of 2019 to determine if the decline in gross receipts test is met. If an employer was not in existence as of the beginning of the fourth calendar quarter of 2019, then the alternative quarter election will not be available for the first calendar quarter of 2021.
>
> For the second calendar quarter of 2021, an employer may elect to use its gross receipts for the first calendar quarter of 2021 compared to those for the first calendar quarter of 2019 to determine if the decline in gross receipts test is met. If an employer was not in existence as of the beginning of the first calendar quarter of 2019, then that employer may elect to measure the decline in gross receipts for the second calendar quarter of 2021 using its gross receipts for the first calendar quarter of 2021 compared to those for the first calendar quarter of 2020.[489]

The Notice appears to provide that the employer will not necessarily be telling the IRS which quarter it tested on the Form 941, but rather must keep records that include showing which quarter was used to justify the ability to claim the credit:

> Eligible employers must maintain documentation to support the determination of the decline in gross receipts, including which calendar quarter an eligible employer elects to use in measuring the decline. An election to use an alternative quarter to calculate gross receipts is made by claiming the employee retention credit for the quarter using the alternative quarter to calculate gross receipts.[490]

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[488] Notice 2021-23, Section III.B
[489] Notice 2021-23, Section III.C
[490] Notice 2021-23, Section III.C

Maximum Amount of Employee Retention Credit per Employee

The Notice points out the larger amount of credit that employers can qualify for per employee under the early 2021 version of the ERC. For 2020 an employer's maximum credit was $5,000 per employee for the year, being 50% of no more than $10,000 of qualified wages (including health care costs) paid during 2020 per employee. The maximums for the first and second quarter of 2021 are outlined in the Notice:

> For the first and second calendar quarters of 2021, section 2301(a) of the CARES Act, as amended by section 207(b) of the Relief Act, provides that the employee retention credit equals 70 percent of qualified wages (including allocable qualified health plan expenses) that an eligible employer pays in a calendar quarter. Section 2301(b)(1) of the CARES Act, as amended by section 207(c) of the Relief Act, limits the amount of qualified wages (including allocable qualified health plan expenses) with respect to any employee that may be taken into account under section 2301(a) of the CARES Act to $10,000 for any calendar quarter; thus the maximum credit for qualified wages (including allocable qualified health plan expenses) paid to an employee is $7,000 for each of the first and second calendar quarters in 2021 (for a total of $14,000).[491]

Increase in the Size of Small Employers

Under the 2020 ERC, employers whose average number of full-time employees during 2020 was 100 or fewer could claim the credit paid during eligible periods for all employees of the employer paid during that period. For employers where the average was greater than 100 employees, the credit was only allowed to be claimed for employees who did not provide services.

Under the 2021 ERC, more employers will now meet the small employer test, allowing those employers to claim the credit for employees regardless of whether or not they are performing services during that period:

> Section 2301(c)(3)(A)(i) of the CARES Act, as amended by section 207(e)(1) of the Relief Act, provides that large eligible employers are eligible employers for which the average number of full-time employees during 2019 was greater than 500 (2021 large eligible employers). Section 2301(c)(3)(A)(ii) of the CARES Act, as amended by section 207(e)(1) of the Relief Act, provides that small eligible employers are eligible employers for which the average number of full-

[491] Notice 2021-23, Section III.D

> time employees during 2019 was not greater than 500 (2021 small eligible employers).[492]

Advance Payment Rules

The IRS provides a series of details about the advance payment rules for the first and second quarter of 2021. The Notice begins by noting that in the 2020 version of the ERC, all employers could receive an advance payment, and there were no limits on that advance:

> Section III.J. of Notice 2021-20 provides various rules related to claiming the employee retention credit, including the circumstances under which an eligible employer may request an advance payment of the employee retention credit. For calendar quarters in 2020 there was no restriction on the types of eligible employers that could claim an advance, nor was there a maximum advance amount other than the amount of the employee retention credit eligible to be claimed, subject to the requirement that an eligible employer reduce deposits in anticipation of the credit before requesting an advance.[493]

However, the Notice provides that in the 2021 version of the ERC, advance payments are only available to certain employers and are limited in amount:

> Section 2301(j) of the CARES Act, as amended by section 207(g) of the Relief Act, prohibits the advance payment of the employee retention credit except to 2021 small eligible employers. Section 2301(j)(2) of the CARES Act, as amended, provides that 2021 small eligible employers may elect to receive an advance payment of the employee retention credit in an amount not to exceed 70 percent of the average quarterly wages paid in calendar year 2019 (the 70 percent advance rule). The requirement to reduce deposits in anticipation of the credit before requesting an advance continues to apply to 2021 small eligible employers.[494]

The Notice contains information on computing the average quarterly wages limit:

> Section 2301 of the CARES Act does not define the term "average quarterly wages." The Treasury Department and the IRS have determined that for purposes of the 70 percent advance rule the term "average quarterly wages" generally means the average of wages (as defined in section 3121(a) of the Code), or compensation (as defined in section 3231(e) of the Code), both determined without regard to the social security wage base, paid in each calendar quarter in 2019.

[492] Notice 2021-23, Section III.E
[493] Notice 2021-23, Section III.F
[494] Notice 2021-23, Section III.F

> The aggregation rules described in section III.B. of Notice 2021-20 apply to the determination of an eligible employer's average quarterly wages. Accordingly, the average quarterly wages for the 70 percent advance rule are calculated based on the quarterly wages paid by all members of the aggregated group.[495]

The Notice begins by describing the calculation for employers who file the quarterly Form 941:

> For 2021 small eligible employers who file Form 941, Employer's Quarterly Federal Tax Return, average quarterly wages for the 70 percent advance rule are calculated by averaging the amount required to be reported on Line 5c, "Taxable Medicare wages & tips," on all Forms 941 required to be filed by a small eligible employer for wages paid in 2019.[496]

For employers that file an annual federal employment tax return, the Notice provides:

> For 2021 small eligible employers that file an annual federal employment tax return, "average quarterly wages" for the 70 percent advance rule are calculated by dividing the amount required to be reported on the following forms and lines, as applicable, by four:

- Line 4, "Total wages subject to Medicare tax," on the 2019 Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees*;
- Line 4c, "Taxable Medicare wages and tips," on the 2019 Form 944, *Employer's Annual Federal Tax Return*;
- The sum of the amounts in the "Compensation" columns of Line 2, "Tier 1 Employer Medicare Tax—Compensation (other than tips and sick pay)," and Line 9, "Tier 1 Employer Medicare Tax—Sick Pay," on the 2019 Form CT-1, *Employer's Annual Railroad Retirement Tax Return*.

Special rules are described for computing this average wage amount for seasonal employers:

> Section 2301(j)(2) of the CARES Act provides special rules for determining average quarterly wages for 2021 small eligible employers that are seasonal employers and 2021 small eligible employers not in existence in 2019. Under section 2301(j)(2)(B), 2021 small eligible employers that employ seasonal workers (as defined in section 45R(d)(5)(B) of the Code) may elect to determine the average quarterly wages based on the wages for the calendar quarter in 2019

[495] Notice 2021-23, Section III.F
[496] Notice 2021-23, Section III.F

> which corresponds to the calendar quarter to which the election relates rather than the average quarterly wages paid in calendar year 2019. A 2021 small eligible employer that employs seasonal workers elects to use the special rule by requesting an advance based on the amount of wages for the calendar quarter in 2019 corresponding to the calendar quarter to which the election relates. Under section 2301(j)(2)(C), 2021 small eligible employers not in existence in 2019 may look to the average quarterly wages paid in 2020 for purposes of applying the 70 percent advance rule. A 2021 small eligible employer that was not in existence in 2019 elects to use the special rule by requesting an advance based on the average quarterly wages paid in 2020.[497]

Advance payments are not available for employers who come into existence in 2021:

> The special rules provided by section 2301(j)(2) of the CARES Act do not provide a method for determining average quarterly wages for a 2021 small eligible employer that comes into existence in 2021. Accordingly, 2021 small eligible employers that come into existence in 2021 are ineligible to receive advance payment of the employee retention credit; however, these 2021 small eligible employers, like all eligible employers, may reduce their deposits of employment taxes in anticipation of claiming the employee retention credit on Form 941 (or other applicable federal employment tax return) in accordance with Notice 2020-22.[498]

Finally, the Notice concludes with guidance for employers in existence for only part of 2019 or 2020:

> If an eligible employer was in existence for some, but not all, calendar quarters of 2019 or 2020, average quarterly wages should be determined by dividing the sum of the wages paid in 2019 or 2020, as applicable, by the number of calendar quarters in 2019 or 2020, as applicable, in which that eligible employer existed. For example, an eligible employer that existed in only the second, third, and fourth calendar quarters of 2019 would add the wages paid in each of those calendar quarters and divide the total by 3. If an eligible employer existed for only part of a calendar quarter, that eligible employer should estimate the wages paid in the entire calendar quarter based on the wages paid in the portion of the calendar quarter in which it existed using any reasonable method. For example, if an eligible employer existed for two out of three months in a calendar quarter, that eligible employer may multiply the wages paid in those two months by 1.5 before averaging the wages for that quarter with the wages for the other calendar quarters. If an eligible employer filing a

[497] Notice 2021-23, Section III.F

[498] Notice 2021-23, Section III.F

> Form 943, 944, or CT-1 existed for only part of 2019 or 2020, that eligible employer may use any reasonable method to annualize the wages paid (or compensation for Form CT-1 filers) prior to dividing the amount by four.[499]

SECTION: ERC
IRS NOTICE INDICATES HOW TO DETERMINE ERC-ELIGIBLE WAGES DEEMED USED TO OBTAIN PPP LOAN FORGIVENESS IN 2020

Citation: Notice 2021-20, 3/1/21

The IRS issued updated guidance for the 2020 version of the employee retention credit in Notice 2021-20,[500] taking into account modifications made to the program by the Taxpayer Certainty and Disaster Tax Relief Act of 2020 signed into law on December 27, 2020.

This guidance is limited to the 2020 version of the ERC, and does not take into account changes that took effect on January 1, 2021. The Notice provides:

> The guidance provided in this notice addresses the employee retention credit as it applies to qualified wages paid after March 12, 2020, and before January 1, 2021. This notice does not address the changes made by section 207 of the Relief Act that apply to the employee retention credit for qualified wages paid after December 31, 2020. The Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) will address the modifications made by section 207 of the Relief Act applicable to calendar quarters in 2021 in future guidance.[501]

In a footnote, the IRS summarizes these 2021 changes that will be dealt with in future guidance:

> Section 207 of the Relief Act makes substantial changes to the employee retention credit that apply to qualified wages paid during the first and second quarter of 2021. Among other changes, section 207 of the Relief Act (1) makes the employee retention credit available for eligible employers paying qualified wages that are paid after December 31, 2020, and before July 1, 2021; (2) increases the maximum credit amount that may be claimed per employee (making it equal to 70

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499 Notice 2021-23, Section III.F

500 Notice 2021-20, March 1, 2021, https://www.irs.gov/pub/irs-drop/n-21-20.pdf (retrieved March 1, 2021)

501 Notice 2021-20, Section I

> percent of $10,000 of qualified wages paid to an employee per calendar quarter); (3) expands the category of employers that may be entitled to claim the credit; (4) modifies the gross receipts test; (5) modifies the definition of qualified wages; (6) broadens the denial of double benefit rule and applies it to sections 41, 45A, 45P, 51, and 1396 of the Code; and (7) changes the eligibility to receive advance payments and limits the amount of the advances.[502]

Update of Original FAQ

The Notice updates the IRS's FAQ originally published on the ERC, incorporating the information in that FAQ into this Notice.

> Following the enactment of the CARES Act, the IRS posted Frequently Asked Questions (FAQs) on IRS.gov to aid taxpayers in calculating and claiming the employee retention credit. As of the publication date of this notice, the FAQs have not been updated to reflect the changes made by the Relief Act. This notice incorporates the information provided in the FAQs and addresses additional issues, including the amendments to section 2301 of the CARES Act made by section 206 of the Relief Act. This notice also identifies instances in which section 206 of the Relief Act made changes to section 2301 of the CARES Act that resulted in rules that are substantially similar to the interpretation provided in the FAQs.[503]

The IRS Notice, continuing the format of the original online FAQ, uses a question and answer format for guidance. The topics covered and subsections, where the specific topic's discussion is found in Section III, are:

- A. Eligible Employers
- B. Aggregation Rules
- C. Governmental Orders
- D. Full or Partial Suspension of Trade or Business Operations
- E. Significant Decline in Gross Receipts
- F. Maximum Amount of Employer's Employee Retention Credit
- G. Qualified Wages
- H. Allocable Qualified Health Plan Expenses

[502] Notice 2021-20, Section I, Footnote 2
[503] Notice 2021-20, Section I

- I. Interaction with Paycheck Protection Program (PPP) Loans
- J. Claiming the Employee Retention Credit
- K. Special Issues for Employees: Income and Deduction
- L. Special Issues for Employers: Income and Deduction
- M. Special Issues for Employers: Use of Third-Party Payers
- N. Substantiation Requirements

In this article, we'll look at the most anticipated part of the guidance—how to deal with PPP loans taken out in 2020.

Interaction with Paycheck Protection Program (PPP) Loans

The key change made by the Taxpayer Certainty and Disaster Tax Relief Act of 2020 to the ERC program for 2020 was removing the prohibition on taxpayers claiming the ERC if the taxpayer had obtained a PPP loan, even if none of that loan was forgiven.

Under the modifications found in Section 206 of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, taxpayers could claim the ERC even if they took out a PPP loan, but the same wages could not be used to obtain PPP loan forgiveness and claim the ERC credit. A key unanswered question was how borrowers that had already obtained forgiveness would be able to determine wages that were used for forgiveness.

Under the law, a taxpayer frees up wages to be used for forgiveness by electing not to use such wages on its employment tax return to obtain the ERC:

> Section 2301(g)(1) of the CARES Act, as amended by the Relief Act, permits an eligible employer to elect not to take into account certain qualified wages for purposes of the employee retention credit. An eligible employer generally makes the election by not claiming the employee retention credit for those qualified wages on its federal employment tax return.[504]

However, since employers in 2020 were initially not allowed to claim the credit at all if they obtained a PPP loan, such employers did not claim the credit on any wages. So the IRS, recognizing that fact, has modified the election so it was made when wages were reported as payroll costs on a PPP forgiveness application:

> However, an eligible employer that received a PPP loan is deemed to have made the election under section 2301(g)(1) of the CARES Act for those qualified wages included in the amount reported as payroll costs

[504] Notice 2021-20, Section III.I, Question 49

> on a Paycheck Protection Program Loan Forgiveness Application (PPP Loan Forgiveness Application).[505]

The IRS does recognize that borrowers may very well have listed wages on the application beyond the minimum needed to gain forgiveness of the entire loan, so the agency allows the taxpayer to limit the amount of wages for which the ERC "opt-out" election is made to the minimum necessary to obtain forgiveness based on the *expenses listed on the application filed*:

> Specifically, the amount for which the eligible employer is deemed to have made the election is the amount of qualified wages included in the payroll costs reported on the PPP Loan Forgiveness Application up to (but not exceeding) the minimum amount of payroll costs, together with any other eligible expenses reported on the PPP Loan Forgiveness Application, sufficient to support the amount of the PPP loan that is forgiven. The employee retention credit does not apply to the qualified wages for which the election or deemed election is made.[506]

Similarly, any wages not listed on the PPP forgiveness application are treated as if no election was made to exclude those wages. This would include wages paid outside the covered period for the PPP loan, as well as wages paid in the covered period that are intentionally left off the application.

> An eligible employer is not deemed to have made an election for any qualified wages paid by the eligible employer that are not included in the payroll costs reported on the PPP Loan Forgiveness Application.[507]

As well, the Notice provides that if the borrower is only granted partial forgiveness of the PPP loan, the wages for which the deemed election is made is limited to the minimum amount of wages listed on the application necessary to obtain the requested forgiveness:

> Notwithstanding a deemed election, if an eligible employer reports any qualified wages as payroll costs on a PPP Loan Forgiveness Application to obtain forgiveness of the PPP loan amount, but the loan amount is not forgiven by reason of a decision under section 7A(g) of the Small Business Act, those qualified wages may subsequently be treated as subject to section 2301 of the CARES Act and may be taken into account for purposes of the employee retention credit. If an eligible employer obtains forgiveness of only a portion of the PPP loan amount, then the employer is deemed to have made an election for the minimum amount of qualified wages included in the payroll costs

[505] Notice 2021-20, Section III.I, Question 49
[506] Notice 2021-20, Section III.I, Question 49
[507] Notice 2021-20, Section III.I, Question 49

> reported on the PPP Loan Forgiveness Application necessary to obtain the forgiveness of that amount of the PPP loan.[508]

A number of borrowers who applied for forgiveness in 2020 may have opted to only provide payroll costs on the application form when applying for forgiveness. They may (and likely did) incur non-payroll costs that would have also counted towards forgiveness, but decided there was no reason to provide those costs when the borrower incurred more than enough payroll costs to obtain full forgiveness. The time and effort to determine and document those expenses for the forgiveness application appeared to offer no benefit, so many borrowers made the reasonable decision to not do the work to provide that additional information with the application.

While an understandable conclusion given the then existing law, that decision now may not work out well as the Notice looks only to what was provided on the application to determine the amount of ERC eligible wages that were used to obtain forgiveness—not what *could* have been provided in lieu of such expenses to allow a larger ERC to be claimed. Generally, a borrower only needed to spend 60% of the loan proceeds on payroll costs, a category which is made up of certain costs not eligible for the ERC (such as employer contributions to retirement plans), as well as including wages that, themselves, may not have been ERC eligible.

Thus, a borrower with enough non-payroll costs paid during the covered period could, at worst, limit the deemed election wages to 60% of the loan proceeds and, quite often, lower the amount even more by selecting payroll costs that simply aren't ERC eligible at all (retirement plan contributions) and wages that aren't ERC qualified wages to make up as much of that 60% as possible.

But if such costs were not listed on the application, the taxpayer cannot now go back and demonstrate they had incurred such expenses that could have been listed. The IRS looks only to what was listed on the actual application.

EXAMPLE 1, QUESTION 49, NOTICE 2021-20

Employer A received a PPP loan of $100,000. Employer A is an eligible employer and paid $100,000 in qualified wages that would qualify for the employee retention credit during the second and third quarters of 2020. In order to receive forgiveness of the PPP loan in its entirety, Employer A was required, under the Small Business Administration (SBA) rules, to report a total of $100,000 of payroll costs and other eligible expenses (and a minimum of $60,000 of payroll costs). Employer A submitted a PPP Loan Forgiveness Application and reported the $100,000 of qualified wages as payroll costs in support of forgiveness of the entire PPP loan. Employer A received a decision under section 7A(g) of the Small Business Act in the first quarter of 2021 for forgiveness of the entire PPP loan amount of $100,000.

Employer A is deemed to have made an election not to take into account $100,000 of the qualified wages for purposes of the employee retention credit, which was the amount of qualified wages included in the payroll costs reported on the PPP Loan Forgiveness

[508] Notice 2021-20, Section III.I, Question 49

Application up to (but not exceeding) the minimum amount of payroll costs, together with any other eligible expenses reported on the PPP Loan Forgiveness Application, sufficient to support the amount of the PPP loan that is forgiven. It may not treat that amount as qualified wages for purposes of the employee retention credit.

But the IRS does allow that if the borrower listed more in wages on the form than were necessary to obtain forgiveness that the borrower can reduce the deemed election to that minimum necessary. In Example 2, the IRS gives an example of an employer that only listed qualified wages as items to justify forgiveness, but listed all wages paid in the covered period, not just the minimum necessary to obtain forgiveness.

EXAMPLE 2, QUESTION 49, NOTICE 2021-20

Employer B received a PPP loan of $200,000. Employer B is an eligible employer and paid $250,000 of qualified wages that would qualify for the employee retention credit during the second and third quarters of 2020. In order to receive forgiveness of the PPP loan in its entirety, Employer B was required, under the SBA rules, to report a total of $200,000 of payroll costs and other eligible expenses (and a minimum of $120,000 of payroll costs). Employer B submitted a PPP Loan Forgiveness Application and reported the $250,000 of qualified wages as payroll costs in support of forgiveness of the entire PPP loan. Employer B received a decision under section 7A(g) of the Small Business Act in the first quarter of 2021 for forgiveness of the entire PPP loan amount of $200,000.

Employer B is deemed to have made an election not to take into account $200,000 of the qualified wages for purposes of the employee retention credit, which was the amount of qualified wages included in the payroll costs reported on the PPP Loan Forgiveness Application up to (but not exceeding) the minimum amount of payroll costs, together with any other eligible expenses reported on the PPP Loan Forgiveness Application, sufficient to support the amount of the PPP loan that is forgiven. It may not treat that amount as qualified wages for purposes of the employee retention credit. Employer B is not treated as making a deemed election with respect to $50,000 of the qualified wages ($250,000 reported on the PPP Loan Forgiveness Application, minus $200,000 reported on the PPP Loan Forgiveness Application up to the amount of the loan that is forgiven), and it may treat that amount as qualified wages for purposes of the employee retention credit.

The third example specifically rejects allowing the borrower who had incurred other expenses qualifying for forgiveness but did not list them on the application from being able to use those expenses *not on the PPP loan forgiveness application* from being used to reduce the deemed election to exclude wages from the ERC credit:

EXAMPLE 3, QUESTION 49, NOTICE 2021-20

Employer C received a PPP loan of $200,000. Employer C is an eligible employer and paid $200,000 of qualified wages that would qualify for the employee retention credit during the second and third quarters of 2020. Employer C also paid other eligible expenses of $70,000. In order to receive forgiveness of the PPP loan in its entirety, Employer C was required, under the SBA rules, to report a total of $200,000 of payroll costs and other eligible expenses (and a minimum of $120,000 of payroll costs). Employer C submitted a PPP Loan Forgiveness Application and reported the $200,000 of qualified wages as payroll costs in support of forgiveness of the entire PPP loan, but did not report the other eligible expenses of $70,000. Employer C received a decision under section 7A(g) of the Small Business Act in the first quarter of 2021 for forgiveness of the entire PPP loan amount of $200,000.

Employer C is deemed to have made an election not to take into account $200,000 of qualified wages for purposes of the employee retention credit, which was the amount of qualified wages included in the payroll costs reported on the PPP Loan Forgiveness Application up to (but not exceeding) the minimum amount of payroll costs, together with any other eligible expenses reported on the PPP Loan Forgiveness Application, sufficient to support the amount of the PPP loan that is forgiven. Although Employer C could have reported $70,000 of eligible expenses (other than payroll costs) and $130,000 of payroll costs, Employer C reported $200,000 of qualified wages as payroll costs on the PPP Loan Forgiveness Application. As a result, no portion of those qualified wages reported as payroll costs may be treated as qualified wages for purposes of the employee retention credit. Employer C cannot reduce the deemed election by the amount of the other eligible expenses that it could have reported on its PPP Loan Forgiveness Application.

But, Example 4 provides that if those non-payroll expenses were listed on the application, even though not required to obtain the full forgiveness, the taxpayer now can get credit for those expenses to maximize the ERC eligible wages:

EXAMPLE 4, QUESTION 49, NOTICE 2021-20

Same facts as Example 3, except Employer C submitted a PPP Loan Forgiveness Application and reported the $200,000 of qualified wages as payroll costs, as well as the $70,000 of other eligible expenses, in support of forgiveness of the PPP loan. Employer C received a decision under section 7A(g) of the Small Business Act in the first quarter of 2021 for forgiveness of the entire PPP loan amount of $200,000. In this case, Employer C is deemed to have made an election not to take into account $130,000 of qualified wages for purposes of the employee retention credit, which was the amount of qualified wages included in the payroll costs reported on the PPP Loan Forgiveness Application up to (but not exceeding) the minimum amount of payroll costs, together with the $70,000 of other eligible expenses reported on the PPP Loan Forgiveness Application, sufficient to support the amount of the PPP loan that was forgiven. As a result, $70,000 of the qualified wages reported as payroll costs may be treated as qualified wages for purposes of the employee retention credit.

Example 5 illustrates that you cannot use those other non-payroll costs to reduce necessary payroll costs below the 60% of the loan usage requirement for payroll costs—in this case, despite having paid $90,000 of such costs, the benefit is limited to $80,000 of freed payroll costs since the borrower must have used 60% of the $200,000 loan ($120,000) for payroll costs.

EXAMPLE 5, QUESTION 49, NOTICE 2021-20

Same facts as Example 4, except Employer C paid $90,000 of other eligible expenses, and reported the $200,000 of qualified wages as payroll costs, as well as the $90,000 of other eligible expenses, in support of forgiveness of the entire PPP loan. In this case, Employer C is deemed to have made an election not to take into account $120,000 of qualified wages for purposes of the employee retention credit, which was the amount of qualified wages included in the payroll costs reported on the PPP Loan Forgiveness Application up to (but not exceeding) the minimum amount of payroll costs, together with the $90,000 of other eligible expenses reported on the PPP Loan Forgiveness Application, sufficient to support the amount of the PPP loan that was forgiven. As a result, $80,000 of the qualified wages reported as payroll costs may be treated as qualified wages for purposes of the employee retention credit.

Example 6 raises the issue that not all payroll costs are ERC eligible even if not used for PPP loan forgiveness. In a footnote, the IRS provides the following discussion of such expenses:

Employer D may have payroll costs that are not qualified wages for various reasons. For example, Employer D may be a large eligible employer that paid wages to employees who continued to provide services during the period of a partial suspension of business operations.[509]

The example illustrates how these ineligible expenses can be deemed to be used to obtain forgiveness, again increasing wages eligible for use in computing the employee retention credit:

EXAMPLE 6, QUESTION 49, NOTICE 2021-20

Employer D received a PPP loan of $200,000. Employer D is an eligible employer and paid $150,000 of qualified wages that would qualify for the employee retention credit during the second and third quarters of 2020. In addition to the qualified wages, Employer D had $100,000 of other payroll costs that are not qualified wages and $70,000 of other eligible expenses. In order to receive forgiveness of the PPP loan in its entirety, Employer D was required, under the SBA rules, to report $200,000 of payroll costs and other eligible expenses (and a minimum of $120,000 of payroll costs).

Employer D submitted a PPP Loan Forgiveness Application and reported $130,000 of payroll costs and $70,000 of other eligible expenses, in support of forgiveness of the entire PPP loan. Employer D can demonstrate that the payroll costs reported on the PPP Loan Forgiveness Application consist of $100,000 of payroll costs that are not qualified wages and $30,000 of payroll costs that are qualified wages. Employer D received a decision under section 7A(g) of the Small Business Act in the first quarter of 2021 for forgiveness of the entire PPP loan amount of $200,000.

Employer D is deemed to have made an election not to take into account $30,000 of qualified wages for purposes of the employee retention credit, which was the amount of qualified wages included in the payroll costs reported on the PPP Loan Forgiveness Application up to (but not exceeding) the minimum amount of payroll costs, together with any other eligible expenses reported on the PPP Loan Forgiveness Application, sufficient to support the amount of the PPP loan that is forgiven. It may not treat that amount as qualified wages for purposes of the employee retention credit. Employer D is not deemed to have made an election with respect to the $120,000 of qualified wages that are not included in the payroll costs reported on the PPP Loan Forgiveness Application. Accordingly, Employer D may take into account the $120,000 of qualified wages ($150,000 of qualified wages paid minus $30,000 of qualified wages included in the payroll costs reported on the PPP Loan Forgiveness Application) for purposes of the employee retention credit.

[509] Notice 2021-20, SECTION III, Footnote 17

Example 7 deals with a case where the borrower is denied forgiveness of the loan. In such a case, no deemed election to exclude wages from the ERC is made even though the wages were listed on the application form.

EXAMPLE 7, QUESTION 49, NOTICE 2021-20

Same facts as Example 6 except Employer D's PPP loan is not forgiven by reason of a decision under section 7A(g) of the Small Business Act. Employer D may treat the full $150,000 as qualified wages (the $30,000 of qualified wages included in the payroll costs reported on the PPP Loan Forgiveness Application, plus the additional $120,000 of qualified wages not included in the payroll costs) as qualified wages for purposes of the employee retention credit.

Steps to Be Taken Now

The guidance provides information both for borrowers who have already applied for and received forgiveness, as well as those who have yet to apply. In both cases, advisers must carefully consider how to maximize the ERC credit available to the employer.

Borrowers who have already applied for and received forgiveness have less flexibility, but that doesn't mean that care shouldn't be taken to maximize the credit based on what was listed on the forgiveness application.

- A borrower should first determine the minimum wage amount necessary to support the forgiveness obtained. The 60% calculation is a starting point here, since forgiveness can be no more than payroll costs divided by 0.60. Looked at from the other direction, payroll costs used in forgiveness will have to be at least 60% of the forgiveness obtained.

- Consider how many payroll costs listed on the forgiveness application would not be qualified wages for ERC purposes and use those first to meet the required minimum. That includes, among other things:

  - Wages paid by a large employer to employees performing services

  - Wages paid to employees not eligible to be used for ERC purposes due to the related party rules found at IRC §51(i)(1)

  - Payroll costs such as retirement plan costs and payroll taxes paid to state and local governments

  - Wages paid to an employee in excess of the $10,000 cap on ERC qualified wages for 2020

- After minimizing the ERC-qualified wages used to meet the 60% test, determine if the borrower reported sufficient non-payroll costs to have obtained forgiveness if only this minimum amount of ERC-qualified wages listed on the PPP application are included as leading to forgiveness

- If the non-payroll expenses are not sufficient, determine the minimum amount of qualified wage costs that need to be treated as expenses leading to forgiveness to obtain the forgiveness granted.

For borrowers who have not yet applied for forgiveness, care should be taken in filling out the PPP forgiveness application to be certain enough in non-ERC costs are included on the application so that only the very minimum amount of ERC wages are deemed used to obtain forgiveness. Thus, borrowers will want to make sure they maximize the use of non-payroll costs in obtaining forgiveness, as well as maximizing the use of non-ERC-qualified payroll costs for the minimum payroll costs that must be included in the forgiveness application.

SECTION: 41
MEMORANDUM OUTLINES MINIMUM INFORMATION THAT WILL BE REQUIRED FOR A RESEARCH CREDIT REFUND CLAIM TO BE ACCEPTED

Citation: CCA 20214101F, 10/15/21

The IRS released a News Release[510] and 22-page Chief Counsel Memorandum[511] that set forth information a claim for refund related to the research credit under IRC §41 will be required to contain to be considered a valid claim. The News Release states:

> The IRS has set forth the information that taxpayers will be required to include for a research credit claim for refund to be considered valid. Existing Treasury Regulations require that for a refund claim to be valid, it must set forth sufficient facts to apprise IRS of the basis of the claim. The Chief Counsel memorandum will be used to improve tax administration with clearer instructions for eligible taxpayers to claim the credit while reducing the number of disputes over such claims.[512]

[510] "IRS sets forth required information for a valid research credit claim for refund", IRS News Release IR-2021-203, October 15, 2021, https://www.irs.gov/newsroom/irs-sets-forth-required-information-for-a-valid-research-credit-claim-for-refund (retrieved October 15, 2021)
[511] CCA 20214101F, October 15, 2021, https://www.irs.gov/pub/irs-lafa/20214101f.pdf (retrieved October 15, 2021)
[512] "IRS sets forth required information for a valid research credit claim for refund", IRS News Release IR-2021-203, October 15, 2021

The IRS explains the reasons for releasing this memorandum that will be used to determine if credit claims will be allowed to move forward as follows:

> Effective tax administration entails ensuring taxpayers understand what is required to support the claim for the research and experimentation (R&E) credit. Each year, the IRS receives thousands of R&E claims for credits in the hundreds of millions of dollars from corporations, businesses, and individual taxpayers. Claims for research credit under IRC Section 41 are currently examined in a substantial number of cases and consume significant resources for both the IRS and taxpayers.
>
> The Chief Counsel legal advice released today is the result of ongoing efforts to manage research credit issues and resources in the most effective and efficient manner. By requiring taxpayers to provide the information referenced below, the IRS will be better able to determine upfront if an R&E credit claim for refund should be paid immediately or whether further review is needed.[513]

The News Release summarizes the information requirements found in the memorandum as follows:

> Specifically, the opinion provides that for a Section 41 research credit claim for refund to be considered a valid claim, taxpayers are required to provide the following information at the time the refund claim is filed with the IRS:
>
> - Identify all the business components to which the Section 41 research credit claim relates for that year.
> - For each business component, identify all research activities performed and name the individuals who performed each research activity, as well as the information each individual sought to discover.
> - Provide the total qualified employee wage expenses, total qualified supply expenses, and total qualified contract research expenses for the claim year. This may be done using Form 6765, *Credit for Increasing Research Activities*.[514]

[513] "IRS sets forth required information for a valid research credit claim for refund", IRS News Release IR-2021-203, October 15, 2021

[514] "IRS sets forth required information for a valid research credit claim for refund", IRS News Release IR-2021-203, October 15, 2021

The News Release notes the IRS will phase-in the requirements, with the requirements being strictly enforced beginning in January 2023:

> The IRS will provide a grace period [until January 10, 2022] before requiring the inclusion of this information with timely filed Section 41 research credit claims for refund. Upon the expiration of the grace period, there will be a one-year transition period during which taxpayers will have 30 days to perfect a research credit claim for refund prior to the IRS' final determination on the claim. Further details will be forthcoming; however, taxpayers may begin immediately providing this information.[515]

Advisers who prepare claims for refund for the IRC §41 research credit should begin studying the entire memorandum so that claims will not be returned to the taxpayer beginning early next year, or simply immediately rejected beginning in early 2023.

SECTION: 223
HDHP AND HSA INFLATION ADJUSTED NUMBERS RELEASED FOR 2022

Citation: Revenue Procedure 2021-10, 5/13/21

The IRS has published the annual inflation adjusted amounts that apply to high deductible health plans (HDHPs) and health saving accounts (HSAs) for 2022.[516]

HSA Amounts for 2022

The annual contribution limits for health savings accounts for 2022 will be:

- Self-only coverage: $3,650
- Family coverage: $7,300.[517]

High-Deductible Health Plan Amounts for 2022

To be a high-deductible health plan in 2022, the program must provide for a deductible of:

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[515] "IRS sets forth required information for a valid research credit claim for refund", IRS News Release IR-2021-203, October 15, 2021

[516] Revenue Procedure 2021-25, May 10, 2021, https://www.taxnotes.com/research/federal/irs-guidance/revenue-procedures/irs-announces-2022-inflation-adjusted-amounts-for-hsas/5s76t (retrieved May 16, 2021)

[517] Revenue Procedure 2021-25, May 10, 2021

- Not less than $1,400 for self-only coverage and
- Not less than $2,800 for family coverage.[518]

The maximum out-of-pocket amounts (excluding premiums) payable by the insured under an HDHP for 2022 must be no more than:

- $7,050 for self-only coverage and
- $14,100 for family coverage.[519]

HRA Excepted Benefit Maximum for 2022

The maximum amount that may be made newly available for an excepted benefit HRA in 2022 is $1,800.[520]

SECTION: 274
IRS DETAILS RESTAURANT BUSINESS MEAL EXPENSES ELIGIBLE FOR 100% DEDUCTION

Citation: Notice 2021-25, 4/8/21

The IRS released guidance in Notice 2021-25[521] to deal with the temporary allowance of a 100% deduction for restaurant business meal expenses under IRC §274(n)(2)(D) that was added to the law in December of 2020 by the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (TCDTRA).

Temporary Full Deduction Relief

The Notice describes the TCDTRA's temporary relief as follows:

> Section 274(n)(2) provides exceptions to the 50-percent limitation of deductions for food or beverage expenses. Section 210(a) of the Act added § 274(n)(2)(D) to the Code, which provides a temporary exception to the 50-percent limitation for expenses for food or beverages provided by a restaurant. Section 274(n)(2)(D) applies to amounts paid or incurred after December 31, 2020, and before January 1, 2023.[522]

[518] Revenue Procedure 2021-25, May 10, 2021
[519] Revenue Procedure 2021-25, May 10, 2021
[520] Revenue Procedure 2021-25, May 10, 2021
[521] Notice 2021-25, April 8, 2021, https://www.irs.gov/pub/irs-drop/n-21-25.pdf (retrieved April 8, 2021)
[522] Notice 2021-25, SECTION II

The purpose of this Notice is described as follows:

> To provide certainty to taxpayers in determining whether § 274(n)(2)(D) applies, this notice explains when the temporary 100-percent deduction applies and when the 50-percent limitation continues to apply.[523]

Definition of a Restaurant

One key item to note is that the food or beverage must be provided by a *restaurant*. The Notice provides information on what will qualify as a restaurant for these purposes:

> For this purpose, the term "restaurant" means a business that prepares and sells food or beverages to retail customers for immediate consumption, regardless of whether the food or beverages are consumed on the business's premises.[524]

The definition would allow a full deduction for amounts paid to a business that was selling food solely for take-out, such as a drive-through only business.

However, the Notice excludes food or beverages purchased from a business that primarily sells prepackaged food or beverages not for immediate consumption. The Notice provides the following examples of such businesses:

- Grocery store;
- Specialty food store;
- Beer, wine, or liquor store;
- Drug store;
- Convenience store;
- Newsstand; or
- A vending machine or kiosk.[525]

Food or beverage acquired from any of those businesses will be subject to the 50% deduction limit unless qualified for another exception from that limitation.[526]

The Notice also provides that an employer may not treat as a restaurant:

[523] Notice 2021-25, SECTION II
[524] Notice 2021-25, SECTION III
[525] Notice 2021-25, SECTION III
[526] Notice 2021-25, SECTION III

- Any eating facility located on the business premises of the employer and used in furnishing meals excluded from an employee's gross income under § 119, or

- Any employer-operated eating facility treated as a de minimis fringe under § 132(e)(2), even if such eating facility is operated by a third party under contract with the employer as described in § 1.132-7(a)(3).[527]

SECTION: 274
MEALS & INCIDENTS EXPENSE PORTION OF PER DIEM DEEMED TO BE 100% DEDUCTIBLE RESTAURANT PROVIDED MEALS FOR 2021 AND 2022

Citation: Notice 2021-63, 11/16/21

In Notice 2021-63,[528] the IRS provides guidance on the interaction of the per diem rules found in Revenue Procedure 2019-48[529] and the temporary allowance of a 100% deduction for business meals provided by a restaurant found at IRC §274(n)(2)(D) for amounts paid or incurred in 2021 and 2022.

The Notice describes the per diem rules as follows:

> Section 274(d) generally provides that no deduction is allowed for any traveling expense (including meals while away from home) unless the taxpayer substantiates such expense by adequate records or by sufficient corroborating evidence. However, § 274(d) authorizes the Secretary of the Treasury or her delegate to prescribe by regulation that some or all of the substantiation requirements do not apply in the case of an expense which does not exceed a particular amount. Section 1.274-5(j)(1) of the Income Tax Regulations authorizes the Commissioner of Internal Revenue (Commissioner) to establish a method allowing a taxpayer to treat a specific amount as paid or incurred for meals while traveling away from home instead of substantiating the actual cost. See also § 1.274-5(g).
>
> In Rev. Proc. 2019-48, 2019-51 I.R.B. 1392, the Commissioner provides rules for taxpayers that choose to use a per diem rate to substantiate, under § 274(d) and § 1.274-5, the amount of ordinary and necessary business expenses paid or incurred while traveling away from home for: lodging, meal, and incidental expenses; meals and

[527] Notice 2021-25, SECTION III
[528] Notice 2021-63, November 16, 2021, https://www.taxnotes.com/research/federal/irs-guidance/notices/irs-clarifies-application-of-temporary-meal-expense-deduction/7clyd?h=2021-63
[529] Revenue Procedure 2019-48, November 26, 2019, https://www.taxnotes.com/research/federal/irs-guidance/revenue-procedures/irs-provides-per-diem-rate-rules-for-substantiating-expenses/2b5g2

> incidental expenses only; or incidental expenses only. Taxpayers that follow the rules in Rev. Proc. 2019-48 are deemed to meet the substantiation requirements in § 274(d) for the applicable travel expenses. See, for example, section 4.01 of Rev. Proc. 2019-48. Except for incidental expenses only deductions, all or part of the amount of an expense deemed substantiated under Rev. Proc. 2019-48 is subject to the appropriate limitation under § 274(n) on the deductibility of food or beverage expenses. See section 6.05 of Rev. Proc. 2019-48.[530]

The Notice provides that the IRS will allow taxpayers to treat the meals and incidental expense portion of the per diem allowance as consisting of food and beverages provided by a restaurant:

> Solely for purposes of § 274(n)(2)(D), a taxpayer that properly applies the rules of Rev. Proc. 2019-48 may treat the meal portion of a per diem rate or allowance paid or incurred after December 31, 2020, and before January 1, 2023, as being attributable to food or beverages provided by a restaurant.[531]

The ruling applies to both reimbursements to employees and amounts properly claimed under the per diem rules by self-employed individuals in accordance with Revenue Procedure 2019-48.[532]

SECTION: 274
FINAL REGULATIONS ON PARKING LOT TAX ISSUED BY IRS

Citation: TD 9939, 12/16/20

The IRS has published the final version of the regulations under IRC §274 that eliminates an employer's deduction for the cost of providing some employer-provided transportation and commuting benefits.[533] Proposed regulations were issued on June 23, 2020, and these regulations mainly adopt those regulations, though with some changes.

One interesting change involves an expansion of the exception under IRC §274(e)(8) where the employer can demonstrate the qualified transportation fringe has zero value—that is, the general public would not pay to park a car in the location in question.

Revised regulation §1.274-13(e)(2)(iii) begins:

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[530] Notice 2021-63, November 16, 2021
[531] Notice 2021-63, November 16, 2021
[532] Notice 2021-63, November 16, 2021, Section 4
[533] TD 9939, December 16, 2020, https://www.govinfo.gov/content/pkg/FR-2020-12-16/pdf/2020-27505.pdf (retrieved December 16, 2020)

> (iii) Expenses for transportation in a commuter highway vehicle, transit pass, or parking sold to customers. Under section 274(e)(8) and this paragraph (e)(2)(iii), any expense paid or incurred by a taxpayer for transportation in a commuter highway vehicle, a transit pass, or parking that otherwise qualifies as a qualified transportation fringe to the extent such transportation, transit pass, or parking is sold to customers in a bona fide transaction for an adequate and full consideration in money or money's worth, is not subject to the disallowance of deductions provided for in paragraph (a) of this section. For purposes of this paragraph (e)(2)(iii), the term customer includes an employee of the taxpayer who purchases transportation in a commuter highway vehicle, a transit pass, or parking in a bona fide transaction for an adequate and full consideration in money or money's worth.[534]

The inclusion of employees in the class of customers is crucial for the exception noted, as they may very well be the only "customers" for purchasing the benefit. The regulation goes on to note that if the true fair value is zero, the use by the employee may count as a sale even though the item is not actually sold to the employee.

> If in a bona fide transaction, the adequate and full consideration for qualified parking is zero, the exception in this paragraph (e)(2)(iii) applies even though the taxpayer does not actually sell the parking to its employees.[535]

But the regulation notes the burden will be on the employer to demonstrate that there is truly zero value to the benefit offered, so that paying nothing represents a deemed sale.

> To apply the exception in this case, the taxpayer bears the burden of proving that the fair market value of the qualified parking is zero.[536]

The regulation does create a safe harbor for certain employers where the value will be deemed to be zero, thus qualifying the employer to deduct all expenses related to the parking area.

> However, solely for purposes of this paragraph (e)(2)(iii), a taxpayer will be treated as satisfying this burden if the qualified parking is provided in a rural, industrial, or remote area in which no commercial parking is available and an individual other than an employee ordinarily would not pay to park in the parking facility.[537]

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534 Reg §1.274-13(e)(2)(iii)
535 Reg §1.274-13(e)(2)(iii)
536 Reg §1.274-13(e)(2)(iii)
537 Reg §1.274-13(e)(2)(iii)

The final regulations add the following example to demonstrate the application of this zero fair market value rule:

REG. §1.274-13(F)(11)—EXAMPLE OF ZERO FAIR VALUE DEEMED SALE

Example 11. Taxpayer K operates an industrial plant with a parking facility in a rural area in which no commercial parking is available. K provides qualified parking at the plant to its employees free of charge. Further, an individual other than an employee ordinarily would not consider paying any amount to park in the plant's parking facility.

Although K does not charge its employees for the qualified parking, the exception in section 274(e)(8) and this paragraph (e)(3)(iii) will apply to K's total parking expenses if in a bona fide transaction, the adequate and full consideration for the qualified parking is zero. In order to treat the adequate and full consideration as zero, K bears the burden of proving that the parking has no objective value. K is treated as satisfying this burden because the parking is provided in a rural area in which no commercial parking is available and in which an individual other than an employee ordinarily would not consider paying any amount to park in the parking facility. Therefore, the exception in paragraph (e)(2)(iii) of this section applies to K's total parking expenses and a deduction for the expenses is not disallowed by reason of section 274(a)(4).

Note that it's not clear how willing the IRS will be to accept an argument of the "worthlessness" of a parking benefit if a taxpayer does not meet the safe harbor where the employer is not located in a rural, industrial or remote area. For instance, would the IRS find "no value" if there are no paid parking lots in a suburban area (so the general public would not normally pay to park in that area), even though it's highly likely the employer would object to anyone who is not an employee making use of the parking.

SECTION: 280F
IRS ANNOUNCES DEPRECIATION AND LEASE INCLUSION AMOUNTS ON VEHICLES FOR 2021

Citation: Revenue Procedure 2021-31, 8/6/21

The IRS has published the revised depreciation limits for vehicles under IRC §280F(d)(7) in Revenue Procedure 2021-31.[538] The limits on depreciation for such assets are adjusted for inflation each year.

For passenger automobiles acquired after September 27, 2017 and placed in service during 2021, the limitation on depreciation if §168(k)'s bonus depreciation applies is:

- 1st tax year - $18,200

[538] Revenue Procedure 2021-31, August 6, 2021, https://www.taxnotes.com/research/federal/irs-guidance/revenue-procedures/irs-announces-limits-on-depreciation-deduction-for-cars/76zx8 (retrieved August 13, 2021)

- 2nd tax year - $16,400
- 3rd tax year - $9,800
- Each succeeding year - $5,860.[539]

For such a passenger automobile where §168(k)'s bonus depreciation rules do not apply, including when the taxpayer has elected not to have them apply or for vehicles acquired on or before September 27, 2017, the limits are:

- 1st tax year - $10,200
- 2nd tax year - $16,400
- 3rd tax year - $9,800
- Each succeeding year - $5,860.[540]

The revenue procedure also includes a table to determine the lease inclusion amount under Reg. §1.280F-7(a) for passenger automobiles with a lease term beginning in 2021.[541]

SECTION: 401
IRS EXTENDS RELIEF ALLOWING FOR REMOTE WITNESSING OF SIGNING OF PLAN DOCUMENTS THROUGH JUNE 2022, ASKS FOR COMMENTS ON ALLOWING SUCH PROCEDURES PERMANENTLY

Citation: Notice 2021-40, 6/24/21

The IRS has again extended, through June 30, 2022, the temporary relief originally found in Notice 2020-42 and extended by Notice 2021-3 that removes the physical presence requirement for participant elections to be witnessed by a plan representative or a notary public.[542]

Original Relief and First Extension

The Notice describes the original grant of relief and the extension as follows:

539 Revenue Procedure 2021-31, Table 1
540 Revenue Procedure 2021-31, Table 2
541 Revenue Procedure 2021-31, Table 3
542 Notice 2021-40, June 24, 2021, https://www.irs.gov/pub/irs-drop/n-21-40.pdf (retrieved June 24, 2021)

> On March 13, 2020, the President determined that the COVID-19 pandemic was of sufficient severity and magnitude to warrant an emergency determination under the Robert T. Stafford Disaster Relief and Emergency Assistance Act, 42 U.S.C. 5121- 5207. In response to the public health emergency caused by the COVID-19 pandemic and related social distancing precautions, Notice 2020-42, 2020-26 IRB 986, provided temporary relief through December 31, 2020, from the physical presence requirement for any participant election witnessed by a notary public of a state that permits remote electronic notarization or by a plan representative, if certain requirements were satisfied. Notice 2021-3 (1) extended this temporary relief through June 30, 2021, (2) noted that, during this temporary relief period, a participant is still able to have a participant election witnessed in the physical presence of a notary public and have that participant election be accepted by a plan in accordance with § 1.401(a)-21(d)(6)(i), (3) solicited comments on whether relief from the physical presence requirement should be made permanent and, if made permanent, what, if any, procedural safeguards are necessary in order to reduce the risk of fraud, spousal coercion, or other abuse in the absence of a physical presence requirement, and (4) stated that any permanent modification of the physical presence requirement would be made through the regulatory process, thus providing an additional opportunity for stakeholders to provide comments.[543]

Terms of Additional Extension

The Notice provides the following information on the extension:

> This notice extends, for the 12-month period from July 1, 2021, through June 30, 2022, the temporary relief provided in Notice 2021-3, including extension of all the requirements to qualify for that relief. Accordingly, for that 12-month period, a plan may qualify for relief from the physical presence requirement for any participant election witnessed by a notary public or a plan representative using an electronic system that satisfies the applicable requirements specified in section III.A and B of Notice 2021-3.[544]

The referenced provisions provide specific instructions for both the use of a remote notary public and a remote plan representative.

[543] Notice 2021-40, June 24, 2021, Section II BACKGROUND
[544] Notice 2021-40, June 24, 2021, Section II EXTENSION OF RELIEF

Remote Notary Public

If the plan wishes to make use of a notary public who is not physically present, the following provisions apply (with the June 30, 2021 date now being extended to June 30, 2022):

> In the case of a participant election witnessed by a notary public, for the period from January 1, 2021, through June 30, 2021, the physical presence requirement in § 1.401(a)-21(d)(6) is deemed satisfied for an electronic system that uses remote notarization if executed via live audio-video technology that otherwise satisfies the requirements of participant elections under § 1.401(a)-21(d)(6) and is consistent with state law requirements that apply to the notary public.[545]

Remote Plan Representative

Similarly, Notice 2021-3 provided the following rules to be followed if the plan representative will witness the signatures remotely (with the June 30, 2021 date now being extended to June 30, 2022):

> In the case of a participant election witnessed by a plan representative, for the period from January 1, 2021, through June 30, 2021, the physical presence requirement in § 1.401(a)-21(d)(6) is deemed satisfied for an electronic system if the electronic system using live audio-video technology satisfies the following requirements:
>
> (1) The individual signing the participant election must present a valid photo ID to the plan representative during the live audio-video conference, and may not merely transmit a copy of the photo ID prior to or after the witnessing;
>
> (2) The live audio-video conference must allow for direct interaction between the individual and the plan representative (for example, a pre-recorded video of the person signing is not sufficient);
>
> (3) The individual must transmit by fax or electronic means a legible copy of the signed document directly to the plan representative on the same date it was signed;
>
> and
>
> (4) After receiving the signed document, the plan representative must acknowledge that the signature has been witnessed by the plan

[545] Notice 2021-3, December 22, 2020, Section III.A, https://www.taxnotes.com/research/federal/irs-guidance/notices/relief-extended-to-let-plan-participants-sign-elections-remotely/2dbsz?h=2021-3 (retrieved June 24, 2021)

representative in accordance with the requirements of this notice and transmit the signed document, including the acknowledgement, back to the individual under a system that satisfies the applicable notice requirements under § 1.401(a)-21(c).[546]

Could This Be Made Permanent?

As the IRS did in Notice 2021-3, the IRS is asking for comments regarding whether these options should be made permanent rather than reverting to a physical presence requirement on July 1, 2022. The agency is asking in particular for comments on the following items:

- How the temporary removal of the physical presence requirement for participant elections required to be witnessed by a plan representative or a notary public has affected costs and burdens for all parties (e.g.,, participants, spouses, and plans) and whether there are costs and burdens associated with the physical presence requirement that support modifying the requirement on a permanent basis;

- Whether there is evidence that the temporary removal of the physical presence requirement has resulted in fraud, spousal coercion, or other abuse, and how, if the physical presence requirement is permanently modified, increased fraud, spousal coercion, or other abuse may be likely to result from that modification;

- How participant elections are being witnessed, or are expected to be witnessed, as the COVID-19 pandemic abates (e.g.,, whether the availability of in-person notarization has returned, or is expected to return, to pre-COVID19 pandemic levels);

- If guidance permanently modifying the physical presence requirement is issued, what procedures should be established to provide the same safeguards for participant elections as are provided through the physical presence requirement; and

- If guidance permanently modifying the physical presence requirement is issued, whether the guidance should establish procedures for witnessing by plan representatives that are different from procedures for witnessing by notaries.[547]

The IRS is requesting that comments be submitted electronically via the Federal eRulemaking Portal at www.regulations.gov by September 30, 2021. Those submitting comments should type "IRS-2021-40" in the search field to find the location to submit these comments.[548]

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[546] Notice 2021-3, December 22, 2020, Section III.B

[547] Notice 2021-40, June 24, 2021, Section IV. REQUEST FOR COMMENTS

[548] Notice 2021-40, June 24, 2021, Section IV. REQUEST FOR COMMENTS

SECTION: 446
SMALL BUSINESS ACCOUNTING METHOD FINAL REGULATIONS RELEASED

Citation: TD 9942, 1/5/2021

The IRS has issued final regulations[549] to implement the various small business optional accounting rules added to IRC §§263A, 448, 460 and 471 by the Tax Cuts and Jobs Act (TCJA).[550] These rules are generally available to small businesses that are not tax shelters and have average annual gross receipts in the preceding three years not in excess of an amount annually adjusted for inflation. For 2020 the revenue limit is $26 million.[551]

Qualifying entities are:

- Allowed to use the cash basis of accounting (any change of method is treated as a change initiated by the taxpayer and made with the consent of the IRS). [IRC §448(b)(3), (d)(7)]

- Allowed to be exempt from the application of the uniform capitalization rules of IRC §263A [IRC §263A(i)]

- Allowed to be exempt from the requirement to keep inventories under the rules of §471(a) (though such items must either be tracked as if they were non-incidental supplies or treated in conformity with the entity's applicable financial statement/books and records if no AFS exists). [IRC §471(c)]

- Treated as meeting the gross receipts requirement to be treated as a small contractor exempt from the percentage of completion method (this does not impact the second requirement that the expected length of contracts must also be less than 2 years to be exempt from percentage of completion). [IRC §460(e)(1)(B)]

Any change of method required for the above is treated as a change initiated by the taxpayer and made with the consent of the IRS for purposes of IRC §481.

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[549] TD 9942, January 5, 2021, https://public-inspection.federalregister.gov/2020-28888.pdf?utm_medium=email&utm_campaign=pi+subscription+mailing+list&utm_source=federalregister.gov (retrieved January 2, 2021)
[550] REG-132766-18, July 29, 2020, https://www.irs.gov/pub/irs-drop/reg_132766_18.pdf (retrieved July 30, 2020)
[551] Revenue Procedure 2019-44, November 6, 2019, Section 3.21, https://www.irs.gov/pub/irs-drop/rp-19-44.pdf (retrieved July 30, 2020)

Taxpayers May Rely on Final or Proposed Regulations

The IRS issued proposed regulations in the summer of 2020, following with final regulations on January 5, 2021. The final regulations are effective for tax years beginning after January 5, 2021 (so 2022 for calendar year taxpayers).

Taxpayers may elect to rely on the final regulations for years beginning after December 31, 2017:

> However, a taxpayer may apply these regulations for a taxable year beginning after December 31, 2017, and before January 5, 2021, provided that if the taxpayer applies any aspect of these final regulations under a particular Code provision, the taxpayer must follow all the applicable rules contained in these regulations that relate to that Code provision for such taxable year and all subsequent taxable years, and must follow the administrative procedures for filing a change in method of accounting in accordance with §1.446-1(e)(3)(ii). For example, a taxpayer that wants to apply §1.263A-1(j) to be exempt from capitalizing costs under section 263A must apply §1.448-2 to determine whether it is eligible for the exemption. The same taxpayer must apply §1.448-2 to determine whether it is eligible to apply §1.471-1(b) to be exempt from the general inventory rules under section 471(a). However, it may choose not to apply §1.471-1(b) even though it chooses to apply §1.263A-1(j) and §1.448-2.[552]

Alternatively, taxpayers may choose to rely upon the proposed regulations.

> Alternatively, a taxpayer may rely on the proposed regulations for a taxable year beginning after December 31, 2017 and before January 5, 2021 provided that if the taxpayer applies any aspect of the proposed regulations under a particular Code provision, the taxpayer must follow all of the applicable rules contained in the proposed regulations that relate to that Code provision for such taxable year, and follow the administrative procedures for filing a change in method of accounting in accordance with §1.446-1(e)(3)(ii).[553]

Entities Qualifying for Special Small Business Accounting Methods (IRC §448(c))

To qualify to use these special small business methods, a taxpayer must meet requirements outlined in IRC §448(c) and not be a tax shelter as defined in IRC §448(d)(2).

[552] Preamble to TD 9942

[553] Preamble to TD 9942

IRC §448(c) provides the following gross receipts test:

> (c) Gross receipts test
>
> For purposes of this section—
>
> (1) In general
>
> A corporation or partnership meets the gross receipts test of this subsection for any taxable year if the average annual gross receipts of such entity for the 3-taxable-year period ending with the taxable year which precedes such taxable year does not exceed $25,000,000.[554]
>
> (2) Aggregation rules
>
> All persons treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414 shall be treated as one person for purposes of paragraph (1).
>
> (3) Special rules
>
> For purposes of this subsection—
>
> (A) Not in existence for entire 3-year period
>
> If the entity was not in existence for the entire 3-year period referred to in paragraph (1), such paragraph shall be applied on the basis of the period during which such entity (or trade or business) was in existence.
>
> (B) Short taxable years
>
> Gross receipts for any taxable year of less than 12 months shall be annualized by multiplying the gross receipts for the short period by 12 and dividing the result by the number of months in the short period.
>
> (C) Gross receipts
>
> Gross receipts for any taxable year shall be reduced by returns and allowances made during such year.
>
> (D) Treatment of predecessors
>
> Any reference in this subsection to an entity shall include a reference to any predecessor of such entity.
>
> (4) Adjustment for inflation

[554] For 2020 this is set at $26,000,000 under the inflation adjustment provided for at IRC §448(c)(4) and published in Revenue Procedure 2019-44 noted earlier.

> In the case of any taxable year beginning after December 31, 2018, the dollar amount in paragraph (1) shall be increased by an amount equal to—
>
> (A) such dollar amount, multiplied by
>
> (B) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, by substituting "calendar year 2017" for "calendar year 2016" in subparagraph (A)(ii) thereof.
>
> If any amount as increased under the preceding sentence is not a multiple of $1,000,000, such amount shall be rounded to the nearest multiple of $1,000,000.

The IRS has proposed the creation of a new regulation (Proposed Reg. §1.448-2) to apply to years beginning after December 31, 2017, with Reg. §1.448-1 retained to deal with years beginning prior to that date.

The IRS summarized the key differences in the preamble to the proposed regulations as follows:

> These rules are generally similar to the existing regulations under §1.448-1 and §1.448-1T of the Temporary Income Tax Regulations, including the short taxable year rule and the aggregation rule. However, for taxable years beginning after December 31, 2017, the proposed regulations update the rules to reflect the post-TCJA Section 448(c) gross receipts test. These proposed regulations also clarify that the gross receipts of a C corporation partner are included in the gross receipts of a partnership if the aggregation rules apply to the C corporation partner and the partnership.[555]

Gross Receipts Test

Proposed Reg. §1.448-2(c)(2) contains the details of the gross receipts test. The proposed regulation provides generally:

> A corporation meets the gross receipts test of this paragraph (c)(2) if the average annual gross receipts of such corporation for the 3 taxable years (or, if shorter, the taxable years during which such corporation was in existence, annualized as required) ending with such prior taxable year does not exceed the gross receipts test amount provided in paragraph (c)(2)(v) of this section (section 448(c) gross receipts test). In the case of a C corporation exempt from Federal income taxes under section 501(a), or a trust subject to tax under section 511(b)

[555] REG-132766-18, July 29, 2020, https://www.irs.gov/pub/irs-drop/reg_132766_18.pdf, p. 13

> that is treated as a C corporation under paragraph (b)(1) of this section, only gross receipts from the activities of such corporation or trust that constitute unrelated trades or businesses are taken into account in determining whether the gross receipts test is satisfied. A partnership with a C corporation as a partner meets the gross receipts test of paragraph (c)(2) of this section if the average annual gross receipts of such partnership for the 3 taxable years (or, if shorter, the taxable years during which such partnership was in existence annualized as required) ending with such prior year does not exceed the gross receipts test amount of paragraph (c)(2)(v) of this section. Except as provided in paragraph (c)(2)(ii) of this section, the gross receipts of the corporate partner are not taken into account in determining whether a partnership meets the gross receipts test of paragraph (c)(2) of this section.[556]

Related entities are aggregated for purposes of this test. Proposed Reg. §1.448-1(c)(2)(ii) provides that the aggregation rules remain the same as they were, referencing Reg. §1.448-1T(f)(2)(ii). That rule provides:

> (ii) Aggregation of gross receipts.
>
> For purposes of determining whether the $5,000,000 gross receipts test has been satisfied, all persons treated as a single employer under section 52(a) or (b), or section 414 (m) or (o) (or who would be treated as a single employer under such sections if they had employees) shall be treated as one person. Gross receipts attributable to transactions between persons who are treated as a common employer under this paragraph shall not be taken into account in determining whether the $5,000,000 gross receipts test is satisfied.[557]

For purposes of applying the gross receipts test, aggregation rules under IRC §§52(a), (b), 404(m) and (o) are used to combine related entities. Thus, the entities that must be combined are:

- Under IRC §52(a) and (b):
  - A set of corporations that would be a controlled group of corporations under IRC §1563(a) if "more than 50 percent" were substituted for "at least 80 percent" each place it appears in §1563(a)(1) (the parent-subsidiary test);
  - The determination was made without regard to §§1563(a)(4) and (e)(3); and
  - A similar rule is applied to unincorporated entities

[556] Proposed Reg. §1.448-2(c)(2)(i)
[557] Reg. §1.448-1T(f)(2)(ii)

- An affiliated service group under IRC §414(m); and
- Groups named in the regulations under IRC §414(o) that combine the following when organized to avoid employee benefit requirements:
  - Separate organizations;
  - Employee leasing, or
  - Other arrangements.

The §52 related groups are likely to be the most significant problem advisers will encounter in this area. Those groups are:

- A parent-subsidiary relationship where one or more chains of corporations connected through stock ownership with a common parent corporation if
  - stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each of the corporations, except the common parent corporation, is owned by one or more of the other corporations; and
  - the common parent corporation owns stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of at least one of the other corporations, excluding, in computing such voting power or value, stock owned directly by such other corporations;
- A brother-sister controlled group that consists of two or more corporations if 5 or fewer persons who are individuals, estates, or trusts own stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation; and
- A combined group that consists of three or more corporations each of which is a member of a group of corporations that fit into one of the prior two groups, and one of which
  - Is a common parent corporation included in a parent-subsidiary group, and also
  - Is included in a brother-sister controlled group.[558]

[558] IRC §1563(a) as modified by the language in §52(a)

The proposed regulations also keep the prior rules for treatment of short taxable years[559] found in Temporary Regulation §1.448-1T:

> (iii) Treatment of a short taxable year.
>
> In the case of any taxable year of less than 12 months (a short taxable year), the gross receipts shall be annualized by (A) multiplying the gross receipts for the short period by 12 and (B) dividing the result by the number of months in the short period.[560]

Finally, the same rules for the determination of gross receipts are retained,[561] also coming from Temporary Regulation §1.448-1T:

> The term "gross receipts" means gross receipts of the taxable year in which such receipts are properly recognized under the taxpayer's accounting method used in that taxable year (determined without regard to this section) for federal income tax purposes. For this purpose, gross receipts include total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments, and from incidental or outside sources. For example, gross receipts include interest (including original issue discount and tax-exempt interest within the meaning of section 103), dividends, rents, royalties, and annuities, regardless of whether such amounts are derived in the ordinary course of the taxpayer's trade of business. Gross receipts are not reduced by cost of goods sold or by the cost of property sold if such property is described in section 1221 (1), (3), (4) or (5). With respect to sales of capital assets as defined in section 1221, or sales of property described in 1221 (2) (relating to property used in a trade or business), gross receipts shall be reduced by the taxpayer's adjusted basis in such property. Gross receipts do not include the repayment of a loan or similar instrument (e.g., a repayment of the principal amount of a loan held by a commercial lender). Finally, gross receipts do not include amounts received by the taxpayer with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority. If, in contrast, the tax is imposed on the taxpayer under the applicable law, then gross receipts shall include the amounts received that are allocable to the payment of such tax.[562]

[559] Proposed Reg. §1.448-2(c)(iii)
[560] Temp. Reg. §1.448-1T(f)(2)(iii)
[561] Proposed Reg. §1.448-1(c)(iv)
[562] Temp. Reg. §1.448-1T(f)(2)(iv)

The proposed regulations provide the following example of the application of their provisions:

EXAMPLE, PROPOSED REG. §1.448-2(C)(2)(V)(B)

Taxpayer A, a C corporation, is a plumbing contractor that installs plumbing fixtures in customers' homes or businesses. A's gross receipts for the 2017- 2019 taxable years are $20 million, $16 million, and $30 million, respectively. A's average annual gross receipts for the three taxable-year period preceding the 2020 taxable year is $22 million (($20 million + $16 million + $30 million) / 3 = $22 million. A may use the cash method for its trade or business for the 2020 taxable year because its average annual gross receipts for the preceding three taxable years is not more than the gross receipts test amount of paragraph (c)(2)(vi) of this section, which is $26 million for 2020.

Some of the special rules on the gross receipts test are found outside of the regulations under IRC §448, especially as they apply to individuals. Proposed Reg. §1.263A-1(j)(2) provides the following for testing the gross receipts of individuals to qualify under the gross receipts test:

> Except when the aggregation rules of section 448(c)(2) apply, the gross receipts of a taxpayer other than a corporation or partnership are the amount derived from all trades or businesses of such taxpayer Amounts not related to a trade or business are excluded from the gross receipts of the taxpayer. For example, an individual taxpayer's gross receipts do not include inherently personal amounts, such as personal injury awards or settlements with respect to an injury of the individual taxpayer, disability benefits, Social Security benefits received by the taxpayer during the taxable year, and wages received as an employee that are reported on Form W-2.[563]

The regulation continues to provide that individuals also take into account their proportionate share of gross receipts of partnerships and S corporations for purposes of the gross receipts test:

> Except when the aggregation rules of section 448(c)(2) apply, each partner in a partnership includes a share of the partnership's gross receipts in proportion to such partner's distributive share (as determined under section 704) of items of gross income that were taken into account by the partnership under section 703. Similarly, a shareholder of an S corporation includes such shareholder's pro rata share of S corporation gross receipts taken into account by the S corporation under section 1363(b).[564]

[563] Proposed Reg. §1.263A-1(j)(2)(ii)
[564] Proposed Reg. §1.263A-1(j)(2)(iii)

The proposed regulation gives two examples of applying these rules to individuals:

EXAMPLE 1, PROPOSED REG. §1.263A-1(J)(2)(IV)

Taxpayer A is an individual who operates two separate and distinct trades or businesses that are reported on Schedule C, Profit or Loss from Business, of A's Federal income tax return. For 2020, one trade or business has annual average gross receipts of $5 million, and the other trade or business has average annual gross receipts of $35 million. Under paragraph (j)(2)(ii) of this section, for 2020, neither of A's trades or businesses meets the gross receipts test of paragraph (j)(2) of this section ($5 million + $35 million = $40 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is $26 million).

EXAMPLE 2, PROPOSED REG. §1.263A-1(J)(2)(IV)

Taxpayer B is an individual who operates three separate and distinct trades or businesses that are reported on Schedule C of B's Federal income tax return. For 2020, Business X is a retail store with average annual gross receipts of $15 million, Business Y is a dance studio with average annual gross receipts of $6 million, and Business Z is a car repair shop with average annual gross receipts of $12 million. Under paragraph (j)(2)(ii) of this section, B's gross receipts are the combined amount derived from all three of B's trades or businesses. Therefore, for 2020, X, Y and Z do not meet the gross receipts test of paragraph (j)(2)(i) of this section ($15 million + $6 million + $12 million = $33 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is $26 million).

The above provisions are also found in Proposed Reg. §1.460-3(b)(3) and Proposed Reg. §1.471-1(b)(2).

Tax Shelters

But it's not just the gross receipts test that must be taken into account—even if the prior three years' average gross receipts are below the level for the tax year in question, the taxpayer may still be denied access to these accounting methods if the entity is a tax shelter as defined at IRC §448(d)(3).

That definition reads:

> The term "tax shelter" has the meaning given such term by section 461(i)(3) (determined after application of paragraph (4) thereof). An S corporation shall not be treated as a tax shelter for purposes of this section merely by reason of being required to file a notice of exemption from registration with a State agency described in section 461(i)(3)(A), but only if there is a requirement applicable to all corporations offering securities for sale in the State that to be exempt from such registration the corporation must file such a notice.[565]

[565] IRC §448(d)(3)

The proposed regulations provide the following list of tax shelters for this purpose:

- An enterprise, other than a C corporation, if at any time (including taxable years beginning before January 1, 1987) interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or state agency having the authority to regulate the offering of securities for sale;

- A tax shelter (which seems a circular definition, but this "tax shelter" is a subset of the larger §448(d)(3) tax shelter, this one defined at §6662(d)(2)(C), so we'll refer to this as a *§6662 tax shelter*); or

- A syndicate.[566]

An enterprise other than a C corporation is considered to be one that had a requirement of registration if it meets the following requirements:

> …[A]n offering is required to be registered with a Federal or state agency if, under the applicable Federal or state law, failure to register the offering would result in a violation of the applicable Federal or state law; this rule applies regardless of whether the offering is in fact registered. In addition, an offering is required to be registered with a Federal or state agency if, under the applicable Federal or state law, failure to file a notice of exemption from registration would result in a violation of the applicable Federal or state law, regardless of whether the notice is in fact filed. However, an S corporation is not treated as a tax shelter for purposes of section 448(d)(3) or this section merely by reason of being required to file a notice of exemption from registration with a state agency described in section 461(i)(3)(A), but only if all corporations offering securities for sale in the state must file such a notice in order to be exempt from such registration.[567]

A *§6662 tax shelter* is defined to include:

- A partnership or other entity,

- Any investment plan or arrangement, or

- Any other plan or arrangement,

if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.[568]

The proposed regulations provide for a special presumption of a principal purpose of tax avoidance for certain farming activities:

566 Proposed Reg. §1.448-2(b)(2)(i)
567 Proposed Reg. §1.448-2(b)(2)(ii)
568 IRC §6662(d)(2)(C)(ii)

> …[M]arketed arrangements in which persons carrying on farming activities using the services of a common managerial or administrative service will be presumed to have the principal purpose of tax avoidance if such persons use borrowed funds to prepay a substantial portion of their farming expenses (for example, payment for farm supplies that will not be used or consumed until a taxable year subsequent to the taxable year of payment).[569]

The presumption means the burden will be on the taxpayer to clearly demonstrate that there was not a principal purpose of tax reduction in this arrangement. Note that a *principal purpose* is generally regarded as being a more important purpose than a *significant purpose*. It's not clear why the proposed regulation used that term rather than a presumption of a *significant* purpose.

The category that has traditionally been the most challenging has been the *syndicate* category. IRC §448 refers to the definition found at IRC §461(i)(3) which then references IRC §1256(e)(3)(B). However, the proposed regulation provides a generally self-contained definition that draws from those sections.

The basic definition of a *syndicate* is provided as follows by the proposed regulation:

> …[T]he term syndicate means a partnership or other entity (other than a C corporation) if more than 35 percent of the losses of such entity during the taxable year (for taxable years beginning after December 31, 1986) are allocated to limited partners or limited entrepreneurs.[570]

In these proposed regulations the IRS has opted to continue to use the *allocated* test found in the prior §448 regulations even though §1256(e)(3)(B) itself uses the term *allocable*. Thus, if there is no loss generated for a tax year, the entity will not be a syndicate for that year. But if the entity has both profitable and unprofitable years, it may move in and out of syndicate status depending on the percentage of amounts allocated in loss years to equity holders qualifying as limited entrepreneurs or who are limited partners.

The proposed regulation goes on to define the term *limited entrepreneur*, providing:

> …[T]he term limited entrepreneur has the same meaning given such term in section 461(k)(4).

IRC §461(k)(4) has the actual definition, which provides that a *limited entrepreneur* is a person who:

- Has an interest in an enterprise other than as a limited partner, and

[569] Proposed Reg. §1.448-2(b)(2)(iv)
[570] Proposed Reg. §1.448-2(b)(2)(iii)(A)

- Does not actively participate in the management of such enterprise.[571]

For purposes of the "active participation" test, IRC §1256(e)(3)(C) provides that an entity shall not be treated as held by a limited partner or limited entrepreneur:

- For any period if during such period such interest is held by an individual who actively participates at all times during such period in the management of such entity,
- For any period if during such period such interest is held by the spouse, children, grandchildren, and parents of an individual who actively participates at all times during such period in the management of such entity,
- If such interest is held by an individual who actively participated in the management of such entity for a period of not less than 5 years,
- If such interest is held by the estate of an individual who actively participated in the management of such entity or is held by the estate of an individual if with respect to such individual such interest was at any time described the second bullet, or
- If the IRS determines (by regulations or otherwise) that such interest should be treated as held by an individual who actively participates in the management of such entity, and that such entity and such interest are not used (or to be used) for tax-avoidance purposes.[572]

The 35% loss rule is tested without regard to the limitation on the deduction of business interest found in §163(j).[573] In a separate set of proposed regulations issued a day earlier with regard to the business interest rule, the IRS provided for a similar proposed change in Proposed Reg. §1.1256(3)-2[574] and gave the following example of how to compute whether an undertaking has a loss as follows:

EXAMPLE, PROPOSED REG. §1.1256(3)-2(E)(2)(C)

Entity is an S corporation that is equally owned by individuals A and B. A provides all of the goods and services provided by Entity. B provided all of the capital for Entity but does not participate in Entity's business. For the current taxable year, Entity has gross receipts of $5,000,000, non-interest expenses of $4,500,000, and interest expense of $600,000.

Under the tax syndicate loss testing rules, Entity has a net loss of $100,000 ($5,000,000 minus $5,100,000) for the current taxable year. One half (50 percent) of this loss is allocated to B, a limited owner. Therefore, for the current taxable year, Entity is a syndicate within the meaning of section 1256(e)(3)(B).

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[571] IRC §461(k)(4)
[572] IRC §1256(e)(3)(C)
[573] Proposed Reg. §1.448-2(b)(2)(v)
[574] REG-107911-18, July 28, 2020, https://www.irs.gov/pub/irs-drop/nprm_reg_107911_18.pdf (retrieved July 30, 2020)

In the preamble to the proposed regulations under §163(j) the IRS noted the reason why this special rule is necessary that was cited in comments received by the IRS:

> One commenter asked for clarification on how to compute the amount of losses to be allocated for purposes of determining syndicate status under section 1256(e)(3)(A). The commenter provided a particular fact pattern in which a small business would be caught in an iterative loop of (a) having net losses due to an interest deduction, (b) which would trigger disallowance of the exemption in section 163(j)(3), (c) which would trigger the application of section 163(j)(1) to reduce the amount of the interest deduction, (d) which would then lead to the taxpayer having no net losses and therefore being eligible for the application of section 163(j)(3). To address this fact pattern, the Treasury Department and the IRS have added rules providing that, for purposes of section 1256(e)(3)(B), losses are determined without regard to section 163(j). See proposed §§1.163(j)-2(d)(3) and 1.1256(e)-2(b).[575]

Even with this change, it clearly is possible an undertaking that has been profitable could suddenly become a tax shelter for §448 purposes if it generates a loss for the year. The proposed regulations provide that an entity must change its accounting method for the year it becomes a tax shelter.[576]

Note that this will be true even if the loss is a one-time special event (such as due to an accounting method change adjustment under IRC §481(a)). Taxpayers may need to consider making elections that may be available, opting out of claiming certain tax benefits once the total consequences of becoming a syndicate are considered.[577]

While by default a taxpayer tests for tax shelter status by using the current year's return to see if 35% of losses have been allocated to limited partners or limited entrepreneurs, for purposes of the small business accounting method rules a taxpayer can elect to perform the test based on the prior year's activity:

> …[T]o determine if more than 35 percent of the losses of a venture are allocated to limited partners or limited entrepreneurs, entities may elect to use the allocations made in the immediately preceding taxable year instead of using the current taxable year's allocation.[578]

[575] REG-107911-18, July 28, 2020, https://www.irs.gov/pub/irs-drop/nprm_reg_107911_18.pdf, p. 111

[576] Proposed Reg. §1.448-2(b)(2)(v)

[577] The same syndicate test is applied for purposes of determining if otherwise exempt small taxpayer will nevertheless have to apply the §163(j) limitation rules in the final and proposed §163(j) regulations issued the day before these proposed regulations.

[578] Reg. §1.448-2(b)(2)(iii)(B)(1)

Although the election was binding in future years under the proposed regulations, the IRS in the final regulations decided to revise that rule. As noted in the preamble to the final regulations:

> The Treasury Department and the IRS remain aware of the increased relevance of the definition of tax shelter under section 448(d)(3) after enactment of the TCJA and the practical concerns regarding the determination of tax shelter status for the taxable year. To ameliorate these practical concerns, these final regulations modify the syndicate election provided in proposed §1.448-2(b)(2)(iii)(B) to provide additional relief by making the election an annual election. The Treasury Department and the IRS have determined that an annual election appropriately balances the statutory language with the consistency requirement for use of a method of accounting under section 446(a) and §1.446-1. A cash method taxpayer that is generally profitable year-to-year may experience an unforeseen taxable loss for an anomalous year but return to its profitable position in subsequent years. If the taxpayer allocated more than 35 percent of the taxable loss to limited partners or limited entrepreneurs, the taxpayer would be required to change from the cash method to another method for the anomalous year in accordance with section 448(a)(3). However, that taxpayer would otherwise not be prohibited under section 448(a)(3) to use the cash method in the next profitable taxable year. An annual election under §1.448-2(b)(2)(iii)(B) allows a taxpayer to elect in the loss year to use the allocated taxable income or loss of the immediately preceding taxable year to determine whether the taxpayer is a syndicate under section 448(d)(3) for the current taxable year. The Treasury Department and the IRS have determined that permitting taxpayers to continue to use the cash method, as well as other methods impacted by a determination under section 448(d)(3), in such situations is consistent with the requirements under section 446(a).[579]

The regulations, therefore, in final form, provide the following:

> An election under this paragraph (b)(2)(iii)(B) applies only to the taxable year for which the election is made.[580]

The proposed regulations provide the requirements and limitations for a taxpayer making this election:

> A taxpayer makes this election for the taxable year by attaching a statement to its timely filed original Federal income tax return (including extensions) for such taxable year. The statement must state

[579] TD 9942, January 5, 2020, Summary of Comments and Explanation of Revisions, I. Overview, 2. Changes to Regulations under Section 448

[580] Reg. §1.448.2(b)(2)(iii)(B)(1)

> that the taxpayer is making the election under §1.448-2(b)(2)(iii)(B). In the case of an S corporation or partnership, the election is made by the S corporation or the partnership and not by the shareholders or partners. An election under this paragraph (b)(2)(iii)(B) may not be made by the taxpayer in any other manner. For example, the election cannot be made through a request under section 446(e) to change the taxpayer's method of accounting. A taxpayer may not revoke an election under this paragraph (b)(2)(iii)(B).[581]

The election to determine tax shelter status based on the prior year applies for *all* purposes under the IRC where it is relevant, not just these small business accounting methods. That would include taxpayers to whom the §163(j) business limitation rules would apply should they be treated as a tax shelter.

> Except as otherwise provided in guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter), a taxpayer that makes an election under this paragraph (b)(2)(iii)(B) must apply this election for other provisions of the Code that specifically apply the definition of tax shelter in section 448(a)(3).[582]

The proposed regulations provide the following examples of applying these rules:

EXAMPLE, REG. §1.448-2(B)(2)(III)(B), EXAMPLE 1

Taxpayer B is a calendar year limited partnership, with no active management from its limited partner. For 2019, B is profitable and has no losses to allocate to its limited partner. For 2020, B is not profitable and allocates 60 percent of its losses to its general partner and 40 percent of its losses to its limited partner. For 2021, B is not profitable and allocates 50 percent of its losses to its general partner and 50 percent of its losses to its limited partner. For taxable year 2020, B makes an election under paragraph (b)(2)(iii)(B) of this section to use its prior year allocated amounts. Accordingly, for 2020, B is not a syndicate because B was profitable for 2019 and did not allocate any losses to its limited partner in 2019. For 2021, B is a syndicate because B allocated 50 percent of its 2021 losses to its limited partner under paragraph (b)(2)(ii)(3)(A) of this section. Even if B made an election under paragraph (b)(2)(iii)(B) of this section to use prior year allocated amounts, B is a syndicate for 2021 because B allocated 40 percent of its 2020 losses to its limited partner in 2020. Because B is a syndicate under paragraph (b)(2)(iii)(A) of this section for 2021, B is a tax shelter prohibited from using the cash method for taxable year 2021 under paragraph (b)(2)(i)(B) of this section.

EXAMPLE, REG. §1.448-2(B)(2)(III)(B), EXAMPLE 2

Same facts as Example (1) in paragraph (b)(2)(iii)(C)(1) of this section, except for 2021, B is profitable and has no losses to allocate to its limited partner. For 2020, B makes an election under paragraph (b)(2)(iii)(B) of this section to use its prior year allocated amounts. Accordingly, for 2020, B is not a syndicate because it did not allocate any losses to its limited

[581] Reg. §1.448-2(b)(2)(iii)(B)(2)

[582] Reg. §1.448-2(b)(2)(iii)(B)(1)

partner in 2019. For 2021, B chooses not to make the election under paragraph (b)(2)(iii)(B) of this section. For 2021, B is not a syndicate because it does not have any 2021 losses to allocate to a limited partner. For taxable years 2019, 2020 and 2021, B is not a syndicate under paragraph (b)(2)(iii)(A) of this section and is not prohibited from using the cash method for taxable years 2019, 2020 or 2021 under paragraph (b)(2)(i)(B) of this section.

Cash Basis of Accounting Under IRC §446

While the major change to the optional use of the cash method of accounting was the simple increase in the dollar limit from $5 million to a much higher inflation adjusted number (now $26,000,000) and granting protection to all entity types, the proposed regulations contain items that taxpayers should be aware of if the entity has revenues that float above and below the limit.

Previously, a covered taxpayer who had ever had average revenue above the limit was permanently barred from using the cash method of accounting. As the preamble notes, that requirement was removed from the IRC and has been removed from the proposed regulations.

> The TCJA removed the requirement under section 448(c) that all prior taxable years of a taxpayer must satisfy the Section 448(c) gross receipts test for the taxpayer to qualify for the cash method for taxable years beginning after December 31, 2017. Thus, section 448 no longer permanently prevents a C corporation or a partnership with a C corporation partner from using the cash method for a year subsequent to a taxable year in which its gross receipts first exceed the dollar threshold for the Section 448(c) gross receipts test. Accordingly, the proposed regulations do not require taxpayers to meet the gross receipts test for all prior taxable years in order to satisfy the Section 448(c) gross receipts test.[583]

Taxpayers who find their average revenue for the prior three years has now grown above the limit for the year in question and had previously been using the overall cash method of accounting will be forced to change their accounting method at that time:

> Any taxpayer to whom section 448 applies must change its method of accounting in accordance with the provisions of this paragraph (g). In the case of any taxpayer required by this section to change its method of accounting for any taxable year, the change shall be treated as a change initiated by the taxpayer. A taxpayer must change to an overall accrual method of accounting for the first taxable year the taxpayer is subject to this section or a subsequent taxable year in which the taxpayer is newly subject to this section after previously making a change in method of accounting that complies with section 448

[583] REG-132766-18, July 29, 2020, pp. 16-17

> (mandatory section 448 year). A taxpayer may have more than one mandatory section 448 year. For example, a taxpayer may exceed the gross receipts test of section 448(c) in non-consecutive taxable years. If the taxpayer complies with the provisions of paragraph (g)(3) of this section for its mandatory section 448 year, the change shall be treated as made with the consent of the Commissioner. The change shall be implemented pursuant to the applicable administrative procedures to obtain the automatic consent of the Commissioner to change a method of accounting under section 446(e) as published in the Internal Revenue Bulletin (See Revenue Procedure 2015-13, 2015-5 IRB 419 (or successor) (see §601.601(d)(2) of this chapter)). This paragraph (g) applies only to a taxpayer who changes from the cash method as required by this section. This paragraph (g) does not apply to a change in method of accounting required by any Code section (or applicable regulation) other than this section.[584]

If a taxpayer later falls below the limit, special rules apply if it has been less than five years since the change to the overall accrual method of accounting was mandated due to the average revenue rule:

> A taxpayer that otherwise meets the requirements of paragraph (c) of this section, and that had during any of the five taxable years ending with the taxable year changed its overall method of accounting from the cash method because it no longer met the gross receipts test of section 448(c) provided under paragraph (c) of this section or because it was a tax shelter as provided under paragraph (b)(2) of this section, may not change its overall method of accounting back to the cash method without the written consent of the Commissioner. Requests for consent must follow the applicable administrative procedures to obtain the written consent of the Commissioner to change a method of accounting under section 446(e) as published in the Internal Revenue Bulletin (see also §601.601(d)(2) of this chapter). For rules relating to the clear reflection of income and the pattern of consistent treatment of an item, see section 446 and §1.446-1.[585]

The preamble suggests that the IRS may not be likely to grant this relief if a taxpayer requests it, as the preamble notes:

> A taxpayer that makes multiple changes in its overall method of accounting within a short period of time may not be treating items of income and expense consistently from year to year, and a change back to the cash method within the five year period may not clearly reflect

[584] Proposed Reg. §1.448-2(g)(1)
[585] Proposed Reg. §1.448-2(g)(3)

> income, as required by §1.446-1(a)(2), even if section 448 otherwise does not prohibit the use of the cash method.[586]

Inventories Under IRC §471

The regulations provide some additional explanations of how a taxpayer who opts to use the provisions of §471(c) to avoid the standard inventory rules of §471 will handle the accounting for items that are normally in inventory.

Reg. §1.471-1(b)(3) describes the small business inventory options as follows:

> A taxpayer eligible to use, and that chooses to use, the exemption described in paragraph (b) of this section may account for its inventory by either:
>
> (i) Using a method that treats its inventory as non-incidental materials and supplies (section 471(c) NIMS inventory method), as described in paragraph (b)(4) of this section; or
>
> (ii) Using the method for each item that is reflected in the taxpayer's applicable financial statement (AFS) (AFS section 471(c) inventory method); or, if the taxpayer does not have an AFS for the taxable year, the books and records of the taxpayer prepared in accordance with the taxpayer's accounting procedures, as defined in paragraph (b)(6)(ii) of this section (non-AFS section 471(c) inventory method)..

Inventory Treated as Non-Incidental Materials and Supplies

If the taxpayer opts to treat inventory as non-incidental materials and supplies (referred in the regulations as the NIMS §471(c) method), the taxpayer initially capitalizes the items that would have made up inventory and then recovers the costs in the latter of the taxable year when:

- Such inventory is actually used or consumed in the taxpayer's business, which is the taxable year in which the taxpayer provides the items to its customer; or
- The taxable year in which the taxpayer pays for (for a taxpayer using the overall cash method of accounting) or incurs (for a taxpayer using the overall accrual method of accounting) the costs of the items.[587]

The *Blue Book* for the Tax Cuts and Jobs Act had suggested a taxpayer electing the option to treat inventory items as materials and supplies could use the *de minimis* election provisions found at Reg. §1.263(a)-1(f) to immediately write off formerly inventory items that cost less than $2,500 (or $5,000 if the taxpayer had an applicable

[586] REG-132766-18, July 29, 2020, p. 17

[587] Proposed Reg. §1.471-1(b)(4)(i)

financial statement).[588] However, the regulations provide for just the opposite, barring the use of the Reg. §1.263(a)-1(f) *de minimis* election to achieve zero inventories.[589]

As the IRS explained in the preamble to the proposed regulations:

> Two commenters asked for clarification on whether a taxpayer using the nonincidental materials and supplies method under section 471(c)(1)(B)(i) may use the de minimis safe harbor election of §1.263(a)-1(f). As discussed in part 4.B of this Explanation of Provisions, the Treasury Department and the IRS continue to interpret inventory treated as non-incidental materials and supplies as remaining characterized as inventory property. Consequently, proposed §1.471-1(b)(4)(i) provides that inventory treated as section 471(c) non-incidental materials and supplies is not eligible for the de minimis safe harbor election under §1.263(a)-1(f). Extending the regulatory election under §1.263(a)-1(f) to encompass section 471(c) materials and supplies is outside the intended scope of the election and runs counter to section 471(c), which indicates section 471(c) materials and supplies are inventory property.[590]

Reg. §1.471-1(b)(4)(i) provides, in part, "The costs of inventory are treated as non-incidental materials and supplies under this paragraph (b)(4) are not eligible for the *de minimis* safe harbor election under §1.263(a)-1(f)(2)."

The costs included under the §471(c) NIMS method include direct material costs, but not direct labor costs.[591] The IRS explained this difference in the preamble to the final regulations:

> The Treasury Department and the IRS acknowledge that there was uncertainty under Revenue Procedure 2001-10 and Revenue Procedure 2002-28 as to whether direct labor and overhead costs were required to be capitalized under the non-incidental materials and supplies method permitted by those revenue procedures. The Treasury Department and the IRS are also aware that tracking of direct labor costs may be burdensome, and in some cases, difficult to do for many small businesses. The Treasury Department and the IRS agree with the commenters' request that direct labor costs be excluded from the inventory costs required to be included in inventory treated as non-incidental materials and supplies. As a result, these final regulations provide that inventory costs includible in the section 471(c) NIMS

[588] Joint Committee on Taxation, *General Explanation of Public Law 115-97*, JCS 1-18, December 2018, p. 113
[589] Reg. §1.471-1(b)(4)(i)
[590] REG-132766-18, July 29, 2020, p. 30
[591] Reg. §1-471-1(b)(4)(ii)

> inventory method are direct material costs of the property produced or the costs of property acquired for resale.[592]

The regulations provide that taxpayers identify the costs of the deemed non-incidental materials and supplies under this method as follows:

> A taxpayer may determine the amount of the costs of its inventory treated as non-incidental materials and supplies that are recoverable through costs of goods sold by using either a specific identification method, a first-in, first-out (FIFO) method, or an average cost method, provided that method is used consistently. See §1.471-2(d). A taxpayer that uses the section 471(c) NIMS inventory method may not use any other method described in the regulations under section 471, or the last-in, first-out (LIFO) method described in section 472 and the accompanying regulations, to either identify inventory treated as non-incidental materials and supplies, or to value that inventory treated as non-incidental materials and supplies. The inventory costs includible in the section 471(c) NIMS inventory method are the direct material costs of the property produced or the costs of property acquired for resale. However, an inventory cost does not include a cost for which a deduction would be disallowed, or that is not otherwise recoverable but for paragraph (b)(4) of this section, in whole or in part, under a provision of the Internal Revenue Code[593]

The regulation goes on to provide the following options for a taxpayer to allocate the various costs to items of material and supplies:

> A taxpayer treating its inventory as non-incidental materials and supplies under this paragraph (b)(4) may allocate the costs of such inventory by using specific identification or any other reasonable method[594]

The regulations provide the following example of applying the non-incidental materials and supplies option for taxpayers opting to use the small business option under IRC §471(c):

EXAMPLE, REG. §1.471-1(B)(4)(IV)

Taxpayer D is a baker that reports its baking trade or business on Schedule C, Profit or Loss From Business, of the Form 1040, Individual Tax Return, and D's baking business has average annual gross receipts for the 3-taxable years prior to 2019 of less than $100,000. D meets the gross receipts test of section 448(c) and is not prohibited from using the cash method under

592 TD 9942, Summary of Comments and Explanation of Revisions, I. Overview, 3. Section 471 Small Business Taxpayer Exemptions, iii. Direct Labor

593 Reg. §1.471-1(b)(4)(ii)

594 Reg. §1.471-1(b)(4)(iii)

section 448(a)(3) in 2019. Therefore, D qualifies as a small business taxpayer under paragraph (b)(2) of this section. D uses the overall cash method, and the section 471(c) NIMS inventory method. D purchases $50 of peanut butter in November 2019. In December 2019, D uses all of the peanut butter to bake cookies available for immediate sale. D sells those peanut butter cookies to customers in January 2020. The peanut butter cookies are used or consumed under paragraph (b)(4)(i) of this section in January 2020 when the cookies are sold to customers, and D may recover the cost of the peanut butter in 2020.

Taxpayers may have hoped that the IRS would have allowed the taxpayers to treat the item as "used" when incorporated into the product, but the agency has decided that it only counts when the product incorporating the item is in the hands of a customer.

Taxpayers Using the AFS Method

If a taxpayer does not wish to use the materials and supplies option and has an applicable financial statement, the taxpayer's only other option under IRC §471(c) is to use what is referred to in the regulations as the *AFS Section 471(c) Method*.

An *applicable financial statement* (AFS) has the same meaning for these purposes as it does under IRC §451(b)(3). Reg. §1.451-3(b)(5) defines an applicable financial statement as follows:

> …[T]he terms *applicable financial statement* and *AFS* are synonymous and mean the taxpayer's financial statement listed in paragraph (b)(5)(i) through (iii) of this section that has the highest priority, including priority within paragraphs (b)(5)(i)(B) and (b)(5)(ii)(B) of this section. The financial statements are, in order of descending priority:
>
> (i) GAAP Statements. A financial statement that is certified as being prepared in accordance with United States generally accepted accounting principles (GAAP) and is:
>
> (A) A Form 10-K (or successor form), or annual statement to shareholders, filed with the United States Securities and Exchange Commission (SEC);
>
> (B) An audited financial statement of the taxpayer that is used for:
>
> (1) Credit purposes;
>
> (2) Reporting to shareholders, partners, or other proprietors, or to beneficiaries; or
>
> (3) Any other substantial non-tax purpose; or

(C) A financial statement, other than a tax return, filed with the Federal government or any Federal agency, other than the SEC or the Internal Revenue Service (IRS);

(ii) IFRS Statements. A financial statement that is certified as being prepared in accordance with international financial reporting standards (IFRS) and is:

(A) Filed by the taxpayer with an agency of a foreign government that is equivalent to the SEC, and has financial reporting standards not less stringent than the standards required by the SEC;

(B) An audited financial statement of the taxpayer that is used for:

(1) Credit purposes;

(2) Reporting to shareholders, partners, or other proprietors, or to beneficiaries; or

(3) Any other substantial non-tax purpose; or

(C) A financial statement, other than a tax return, filed with the Federal government, Federal agency, a foreign government, or agency of a foreign government, other than the SEC, IRS, or an agency that is equivalent to the SEC or the IRS; or

(iii) Other Statements. A financial statement, other than a tax return, filed with the Federal government or any Federal agency, a state government or state agency, or a self-regulatory organization including, for example, a financial statement filed with a state agency that regulates insurance companies or the Financial Industry Regulatory Authority. Additional financial statements included in this paragraph (b)(5)(iii) may be provided in guidance published in the Internal Revenue Bulletin (see §601.601(d) of this chapter).

(iv) Additional rules for determining priority. If a taxpayer restates AFS revenue for a taxable year prior to the date that the taxpayer files its Federal income tax return for such taxable year, the restated AFS must be used instead of the original AFS. If using the restated AFS revenue results in a change in method of accounting, the preceding sentence applies only if the taxpayer receives permission to change its method of accounting to use the restated AFS revenue. In addition, if a taxpayer with different financial accounting and taxable years is required to file both annual financial statements and periodic financial statements covering less than a year with a government or government agency, the

> taxpayer must prioritize the annual financial statement in accordance with this paragraph (b)(5).[595]

The *AFS Section 471(c) Method* is described in general terms as follows:

> A taxpayer that meets the gross receipts test described in paragraph (b)(2) of this section and that has an AFS for such taxable year may use the AFS section 471(c) inventory method described in this paragraph to account for its inventory costs for the taxable year. For purposes of the AFS section 471(c) inventory method, an inventory cost is a cost of production or resale that a taxpayer capitalizes to inventory property produced or property acquired for resale in its AFS. For purposes of the AFS section 471(c) inventory method, costs that are generally required to be capitalized to inventory under section 471(a) but that the taxpayer does not capitalize to inventory on its AFS are not required to be capitalized to inventory. However, an inventory cost does not include a cost that is neither deductible nor otherwise recoverable but for paragraph (b)(5) of this section, in whole or in part, under a provision of the Internal Revenue Code (for example, section 162(c), (e), (f), (g), or 274). In lieu of the inventory method described in section 471(a), a taxpayer using the AFS section 471(c) inventory method recovers its inventory costs in accordance with the inventory method used in its AFS.[596]

However, the proposed regulations do impose an additional timing limitation, so that the timing of inclusion of an item in cost of sales in an AFS may not control when it appears on the tax return:

> Notwithstanding the timing rules used in the taxpayer's AFS, the amount of any inventoriable cost may not be capitalized or otherwise taken into account for Federal income tax purposes any earlier than the taxable year during which the amount is paid or incurred under the taxpayer's overall method of accounting, as described in §1.446-1(c)(1). For example, in the case of an accrual method taxpayer, inventoriable costs must satisfy the all events test, including economic performance, of section 461. See §1.446-1(c)(1)(ii) and section 461 and the accompanying regulations.[597]

The regulations provide the following example of the application of the AFS Section 471(c) Method:

[595] Reg. §1.451-3(b)(5)

[596] Reg. §1.471-1(b)(5)(i)

[597] Reg. §1.471-1(b)(5)(iii)

EXAMPLE, REG. §1.471-1(5)(IV)

H is a calendar year C corporation that is engaged in the trade or business of selling office supplies and providing copier repair services. H meets the gross receipts test of section 448(c) and is not prohibited from using the cash method under section 448(a)(3) for 2019 or 2020. For Federal income tax purposes, H chooses to account for purchases and sales of inventory using an accrual method of accounting and for all other items using the cash method. For AFS purposes, H uses an overall accrual method of accounting. H uses the AFS section 471(c) inventory method of accounting. In H's 2019 AFS, H incurred $2 million in purchases of office supplies held for resale and recovered the $2 million as cost of goods sold. On January 5, 2020, H made payment on $1.5 million of these office supplies. For purposes of the AFS section 471(c) inventory method of accounting, H can recover the $2 million of office supplies in 2019 because the amount has been included in cost of goods sold in its AFS inventory method and section 461 has been satisfied.

Taxpayers Using the Non-AFS Section 471(c) Method

If a taxpayer does not have an AFS for the taxable year in question, the taxpayer's option other than using the non-incidental materials and supplies method is to use the *Non-AFS Section 471(c) Method* defined at Reg. §1.471-1(b)(6).

The regulation provides the following general discussion of the method:

> A taxpayer that meets the gross receipts test described in paragraph (b)(2) of this section for a taxable year and that does not have an AFS, as defined in paragraph (b)(5)(ii) of this section, for such taxable year may use the non-AFS section 471(c) inventory method to account for its inventories for the taxable year in accordance with this paragraph (b)(6). The non-AFS section 471(c) inventory method is the method of accounting used for inventory in the taxpayer's books and records that properly reflect its business activities for non-tax purposes and are prepared in accordance with the taxpayer's accounting procedures. For purposes of the non-AFS section 471(c) inventory method, an inventory cost is a cost of production or resale that the taxpayer capitalizes to inventory property produced or property acquired for resale in its books and records, except as provided in paragraph (b)(6)(ii) of this section. Costs that are generally required to be capitalized to inventory under section 471(a), but that the taxpayer does not capitalize in its books and records are not required to be capitalized to inventory. However, an inventory cost does not include a cost that is neither deductible nor otherwise recoverable but for paragraph (b)(5) of this section, in whole or in part, under a provision of the Internal Revenue Code (for example, section 162(c), (e), (f), (g), or 274). In lieu of the inventory method described in section 471(a), a taxpayer using the non-AFS section 471(c) inventory method recovers

> its applicable costs through its book inventory method of accounting. A taxpayer that has an AFS for such taxable year may not use the non-AFS section 471(c) inventory method..[598]

One point that a reader may miss in initially reading the provision is the requirement that the method must *properly reflect* the entity's business activities for *non-tax purposes*. Thus, the IRS has left open the option to challenge the taxpayer's book method by arguing the arrangement is purely for tax purposes and the reporting is not appropriate for non-tax purposes.

Taxpayers should be ready to demonstrate actual use of the statements generated unadjusted from the books and records using this method for non-tax purposes. Conversely, if the taxpayer provides lenders with financial statements that use another method to report inventory costs (such as one that is GAAP compliant), the IRS would likely argue the method does not meet the requirements noted in the regulation. In fact, the first example the IRS offers in the regulations for the Non-AFS Section 471(c) Method (reproduced later) specifically deals with this sort of situation.

As with the AFS Section 471(c) Method, the regulations also contain a similar timing rule:

> Notwithstanding the timing of costs reflected in the taxpayer's books and records, a taxpayer may not recover any costs that have not been paid or incurred under the taxpayer's overall method of accounting, as described in §1.446-1(c)(1). For example, in the case of an accrual method taxpayer or a taxpayer using an accrual method for purchases and sales, inventory costs must satisfy the all events test, including economic performance, under section 461(h). See §1.446- 1(c)(1)(ii), and section 461 and the accompanying regulations.[599]

The regulations provide seven examples of the application of these provisions:

EXAMPLE 1, REG. §1.471-1(B)(6)

Taxpayer E is a C corporation that is engaged in the retail trade or business of selling beer, wine, and liquor. In 2019, E has average annual gross receipts for the prior 3-taxable-years of $15 million and is not otherwise prohibited from using the cash method under section 448(a)(3). E does not have an AFS for the 2019 taxable year. E is eligible to use the non-AFS section 471(c) inventory method of accounting. E uses the overall cash method, and the non-AFS section 471(c) inventory method of accounting for Federal income tax purposes. In E's electronic bookkeeping software, E treats all costs paid during the taxable year as presently deductible. As part of its regular business practice, E's employees take a physical count of inventory on E's selling floor and its warehouse on December 31, 2019, and E uses this physical count as part of its books and records for purposes of capitalizing and allocating costs to inventory. E also makes representations to its creditor of the cost of inventory on

[598] Reg. §1.471-1(b)(6)(i)

[599] Reg. §1.471-1(b)(6)(ii)

hand for specific categories of product it sells. E may not expense all of its costs paid during the 2019 taxable year because its books and records do not accurately reflect the inventory records used for non-tax purposes in its regular business activity. Instead, E must use the physical inventory count taken at the end of 2019 to determine how its capitalized costs are allocated and recovered.

EXAMPLE 2, REG. §1.471-1(B)(6)

Same facts as Example (1) in paragraph (b)(6)(iii)(A) of this section but E does not use the physical count to capitalize and allocate costs to inventory and does not make any representations about inventory on hand to any creditors. Although E pays or incurs costs that are generally required to be capitalized to inventory under section 471(a), because such costs are not capitalized to inventory in E’s books and records, they are not required to be capitalized to inventory under paragraph (b)(6)(i) of this section.

EXAMPLE 3, REG. §1.471-1(B)(6)

Same facts as Example (1) in paragraph (b)(6)(iii)(A) of this section but E does not use the physical count to capitalize and allocate costs to inventory in its electronic bookkeeping software and does not make any representations about inventory on hand to any external parties. E does use the physical count to value inventory on hand for internal reports to its shareholders. The internal reports to its shareholders are part of E’s books and records and must be taken into account for E’s non-AFS section 471(c) inventory method. E recovers its inventory costs consistent with its non-AFS section 471(c) inventory method.

EXAMPLE 4, REG. §1.471-1(B)(6)

Taxpayer F is a C corporation that is engaged in the manufacture of baseball bats. In 2019, F has average annual gross receipts for the prior 3-taxable-years of less than $25 million and is not otherwise prohibited from using the cash method under section 448(a)(3). F does not have an AFS for the 2019 taxable year. For Federal income tax purposes, F uses the overall cash method of accounting, and the non-AFS section 471(c) inventory method of accounting. For its books and records, F uses an overall accrual method and maintains inventories. In December 2019, F’s financial statements show $500,000 of direct and indirect material costs. F pays its supplier in January 2020. Under paragraph (b)(6)(ii) of this section, F recovers its direct and indirect material costs in 2020.

EXAMPLE 5, REG. §1.471-1(B)(6)

Taxpayer G is a baker that reports its baking trade or business on Schedule C, Profit or Loss From Business, of the Form 1040, Individual Tax Return. In 2020, G’s baking business has average annual gross receipts for the prior 3- taxable years of less than $100,000 and is not otherwise prohibited from using the cash method under section 448(a)(3). G does not have an AFS for the 2020 taxable year. For Federal income tax purposes, G uses the overall cash method of accounting and the non-AFS section 471(c) inventory method. In G’s books and records for 2020 that properly reflects its business activities for non-tax purposes, G capitalizes the cost of its cookie ingredients to inventory but immediately expenses the cost of labor for G’s employee who bakes the cookies. Under paragraphs (b)(6)(i) and (ii) of this section, G treats as an inventory cost the cost of its cookie ingredients and recovers such costs in accordance with the accounting procedures used to prepare its books and records, or, if later, when paid. Additionally, although the cost of direct labor is generally required to be capitalized to inventory under section 471(a), because such cost is not capitalized to inventory in G's books and records, it is not required to be capitalized to inventory under paragraph (b)(6)(i) of this section. Further, because such direct labor cost is generally deductible under section 162, and not otherwise required to be capitalized under section 263(a), G may deduct the cost of labor in the year G pays that expense.

EXAMPLE 6, REG. §1.471-1(B)(6)

Taxpayer H is a partnership engaged in the resale of beer, wine, and liquor. In 2020, H has average annual gross receipts for the prior 3-taxable-years of less than $25 million and is not otherwise prohibited from using the cash method under section 448(a)(3). H does not have an AFS for the 2020 taxable year. For Federal income tax purposes, H uses the overall cash method of accounting, and the non-AFS section 471(c) inventory method of accounting. For its books and records, H uses the overall cash method. As part of its regular business practice, H's employees take regular physical counts of the inventory on the shop floor and in the storeroom, however H's method of accounting for inventory for its books and records does not allocate costs between ending inventory and cost of goods sold, and instead expenses the cost of the inventory in the year it was paid for. Prior to December 2020, H acquires and pays for $500,000 of beer, wine, and liquor. In addition, on December 1, 2020, H acquires $50,000 in beer and wine, and pays for this beer and wine on December 20, 2020. H may recover as deductions in 2020 the $550,000 of inventory costs.

EXAMPLE 7, REG. §1.471-1(B)(6)

Taxpayer J is a partnership engaged in the resale of beer, wine, and liquor. In 2020, J has average annual gross receipts for the prior 3-taxable-years of less than $25 million and is not otherwise prohibited from using the cash method under section 448(a)(3). J does not have an AFS for the 2020 taxable year. For Federal income tax purposes, J uses the overall cash method of accounting, and the non-AFS section 471(c) inventory method of accounting. For its books and records, J uses the overall cash method. J maintains a point-of-sale computer system that tracks acquisition costs and inventory levels of the beer, wine, and liquor. The ledger is periodically reconciled with physical counts performed by J's employees. J must use the physical inventory count and ledger to determine its ending inventory. J includes in cost of goods sold for 2020 those inventory costs that are not properly allocated to ending inventory.

Section 471(c) Does Not Impact Other IRC Provisions

The regulations also provide that these §471(c) rules do not override any IRC provisions other than the rules at §471(a). The proposed regulations provide:

> Nothing in section 471(c) shall have any effect on the application of any other provision of law that would otherwise apply, and no inference shall be drawn from section 471(c) with respect to the application of any such provision. For example, an accrual method taxpayer that includes inventory costs in its AFS is required to satisfy

> section 461 before such cost can be included in cost of goods sold for the taxable year. Similarly, nothing in section 471(c) affects the requirement under section 446(e) that a taxpayer secure the consent of the Commissioner before changing its method of accounting. If an item of income or expense is not treated consistently from year to year, that treatment may not clearly reflect income, notwithstanding the application of this section. Finally, nothing in section 471(c) permits the deduction or recovery of any cost that a taxpayer is otherwise precluded from deducting or recovering under any other provision in the Code or Regulations.[600]

Accounting Method Issues

The proposed regulations provide that a taxpayer opting to move away from using §471(a) to the provisions found at §471(c) is undergoing a change of accounting methods and must seek the IRS's permission to make the change.[601]

Taxpayers may find they have an AFS in some years and don't have an AFS in other years. If a taxpayer merely changes from the AFS Section 471(c) Method to the Non-AFS Section 471(c) Method or vice versa related to years with/without an AFS, that is not considered to be an accounting method change and IRS permission does not have to be sought.[602]

Uniform Capitalization Rules Under IRC §263A

The IRS has made various changes to the regulations to take into account the small taxpayer's ability to "opt-out" from the application of the uniform capitalization rules of §263A (often referred to as UNICAP).

Small Reseller Exception

The IRS did decide to remove the small reseller gross receipts test from the regulations as being no longer relevant. As the preamble to the proposed regulations noted:

> Prior to the TCJA, the Section 263A small reseller exception in section 263A(b)(2)(B) exempted from section 263A resellers with gross receipts of $10 million or less (small reseller gross receipts test). The TCJA removed the Section 263A small reseller exception provided in section 263A(b)(2)(B).
>
> Consistent with the TCJA, these proposed regulations remove existing §1.263A- 3(a)(2)(ii) and modify existing §1.263A-3(b) by removing the small reseller gross receipts test. The Treasury Department and the

[600] Reg. §1.471-1(b)(7)
[601] Reg. §1.471-1(b)(8)
[602] Reg. §1.471-1(b)(8)

> IRS expect that most taxpayers who previously satisfied the small reseller gross receipts test will meet the Section 448(c) gross receipts test due to the increased dollar threshold in section 448(c), and therefore would be eligible to apply the small business taxpayer exemption under section 263A(i).[603]

However, the IRS notes that this definition was cross-referenced, triggering changes in other regulations due to the above change:

> The definition of gross receipts used for the small reseller gross receipts test under existing §1.263A-3(b) is applied for purposes of other simplifying conventions under the existing section 263A regulations. Since the TCJA removed the small reseller gross receipts test and added the Section 263A small business taxpayer exemption that refers to section 448(c), these proposed regulations update those simplifying conventions by cross referencing to the definition of gross receipts set forth in the proposed regulations under section 448 where applicable.
>
> Specifically, proposed §1.263A-3(a)(5) modifies the definition of gross receipts that is used to determine whether a reseller has de minimis production activities and proposed §1.263A-1(d)(3)(ii)(B)(1) modifies the definition of gross receipts used to permit certain taxpayers to use the simplified production method under §1.263A-2(b) by cross referencing to the definition of "gross receipts" for purposes of the Section 448(c) gross receipts test.[604]

Capitalization of Interest Impact

The proposed regulations also provided that the small business exception under IRC §263A will also apply to cases where interest is required to be capitalized under the provision (such as for self-constructed property) and the preamble to the proposed regulations notes regulatory changes proposed to deal with this issue:

> Prior to the TCJA, section 263A(f)(1) required the capitalization of interest if the taxpayer produced certain types of property (designated property). The Section 263A small business taxpayer exception applies for all purposes of section 263A, including the requirement to capitalize interest under section 263A(f). Accordingly, these proposed regulations modify §1.263A-7 and §1.263A-8 to add new paragraphs to implement the Section 263A(i) small business taxpayer exemption for purposes of the requirement to capitalize interest.
>
> Additionally, existing §1.263A-9 contains an election that permits taxpayers whose average annual gross receipts do not exceed $10

603 REG-132766-18, July 29, 2020, p. 8

604 REG-132766-18, July 29, 2020, pp. 8-9

> million to use the highest applicable Federal rate as a substitute for the weighted average interest rate when tracing debt. Again, the Section 263A small business taxpayer exception applies for all purposes of section 263A, including the election for small business taxpayers who choose to capitalize interest under section 263A(f). Therefore, these proposed regulations modify §1.263A-9 to remove the $10 million gross receipts test in the definition of eligible taxpayer and replace it with the Section 448(c) gross receipts test. The Treasury Department and the IRS have determined that the use of a single gross receipts test under the section 263A (other than the pre-existing higher $50 million threshold for testing eligibility to apply the simplified production method) simplifies application of the UNICAP rules for taxpayers.[605]

Farming Trade or Business Issues

The IRS discusses special issues impacting farming trades or businesses under these new provisions. First, the agency discusses the pre-existing election under IRC §263A(d)(3), noting the pre-existing election and the conditions for using it:

> Prior to the TCJA, section 263A(d)(3) permitted certain taxpayers to elect not to have the rules of section 263A apply to certain plants produced in a farming business conducted by the taxpayer. An electing taxpayer and any related person, as defined in §1.263A-4(d)(4)(iii), are required to apply the alternative depreciation system, as defined in section 168(g)(2), to property used in the taxpayer's and any related persons' farming business and placed in service in the taxable years in which the election was in effect.[606]

Now small farmers may find that, rather than having to live with those restrictions, they would prefer to make use of the small taxpayer accounting method option instead to bypass §263A. The IRS notes:

> The Treasury Department and the IRS are aware that taxpayers that made an election under section 263A(d)(3) may also qualify for the Section 263A small business taxpayer exemption, and may prefer to apply that exemption rather than the election under section 263A(d)(3). Proposed §1.263A-4(d)(5) permits a taxpayer to revoke its section 263A(d)(3) election for any taxable year in which the taxpayer is eligible for and wants to apply the Section 263A small business taxpayer exemption by following applicable administrative guidance, such as Revenue Procedure 2020-13 (2020-11 IRB 515). In addition, some taxpayers may be eligible to apply the election under section 263A(d)(3) in a taxable year in which they cease to qualify for the Section 263A small business taxpayer exemption. Therefore, proposed

[605] REG-132766-18, July 29, 2020, pp. 9-10

[606] REG-132766-18, July 29, 2020, p. 10

> §1.263A-4(d)(6) permits such a taxpayer to change its method of accounting from the exemption under section 263A(i) by making a section 263A(d)(3) election in the same taxable year by following applicable administrative guidance, such as Revenue Procedure 2020-13.[607]

The IRS also notes that they are taking this opportunity to clean up what they now refer to as a drafting error in prior regulations:

> Proposed §1.263A-4(d)(3)(i) is modified to remove the requirement that the election under section 263A(d)(3) by a partnership or S corporation be made by the partner, shareholder or member. The Treasury Department and the IRS believe that the inclusion of this requirement was a drafting error, as sections 703(b) and 1363(c) require the election to be made at the entity level.[608]

As well, the IRS is taking this opportunity to publish regulations on a provision related to citrus plants added by TCJA:

> The TCJA added new section 263A(d)(2)(C), which provides a special temporary rule for citrus plants lost by reason of casualty. The provision, which expires in 2027, provides that section 263A does not apply to replanting costs paid or incurred by a taxpayer other than the owner if certain conditions are met. Proposed §1.263A-4(e)(5) is added to incorporate this special temporary rule.[609]

SECTION: 448
IRS GIVES GUIDANCE ON TIMING OF PPP LOAN RELIEF, AS WELL AS OTHER ISSUES RELATED TO TAX EXEMPT COVID RELIEF PROGRAMS

Citation: Revenue Procedures 2021-48, 2021-49 and 2021-50, 11/18/21

The IRS finally addressed the options for the timing of PPP forgiveness for tax purposes in Revenue Procedure 2021-48[610] as well as issuing two related procedures at the same time dealing with related issues. This includes a very limited time period when an

[607] REG-132766-18, July 29, 2020, p. 10
[608] REG-132766-18, July 29, 2020, p. 11
[609] REG-132766-18, July 29, 2020, p. 11
[610] Revenue Procedure 2021-48, November 18, 2021, https://www.taxnotes.com/research/federal/irs-guidance/revenue-procedures/irs-clarifies-when-to-claim-tax-exempt-ppp-forgiveness-amounts/7cm9r

affected BBB partnership can file an amended income tax return in lieu of filing the otherwise required Administrative Adjustment Request.

Timing of Income Inclusion

The procedure provides that a taxpayer may treat tax-exempt income as received or accrued from a PPP loan under any of the following three methods:

- The tax-exempt income may be recognized as, and to the extent that, the taxpayer pays or incurs eligible expenses leading to forgiveness. Under this option, a taxpayer that has elected to use the safe harbor provided under Revenue Procedure 2021-20 will be treated as paying or incurring the eligible expenses during the taxpayer's immediately subsequent taxable year following the taxpayer's 2020 taxable year in which the expenses were actually paid or incurred, as described in Revenue Procedure 2021-20;

- When the taxpayer files an application for forgiveness of the PPP Loan; or

- When the PPP Loan forgiveness is granted.[611]

The Procedure describes Revenue Ruling 2021-20, noted above, as follows:

> Revenue Procedure 2021-20, 2021-19 I.R.B. 1150 (May 10, 2021), provides a safe harbor that allows certain taxpayers that, under prior guidance issued by the Treasury Department and the Internal Revenue Service, did not deduct certain otherwise deductible PPP-related expenses on a tax return that was filed prior to the enactment of the COVID Tax Relief Act to deduct such expenses in the next taxable year (that is, the taxable year following the taxable year in which such expenses were paid or incurred).[612]

If PPP Loan is Not Fully Forgiven

The Revenue Procedure provides the following provisions that apply if, after using these methods, the PPP Loan is ultimately not fully forgiven:

> Unless otherwise provided in the 2021 filing year form instructions, if the taxpayer receives forgiveness for an amount of the PPP Loan that is less than the amount that the taxpayer previously treated as tax-exempt income, the taxpayer must make appropriate adjustments on an amended Federal income tax return, information return or AAR, as applicable, for the taxable year(s) in which the taxpayer treated tax-exempt income from the forgiveness of such PPP Loan as received or accrued. Partners and shareholders that receive amended Forms K-1 as

[611] Revenue Procedure 2021-48, November 18, 2021
[612] Revenue Procedure 2021-48, November 18, 2021

> provided in this section 3.03 must file amended Federal income tax returns, information returns or AARs, as applicable, consistent with the Forms K-1 received.[613]

The Procedure requires that taxpayers who use these methods must apply them consistently for Federal income tax purposes:

> To the extent tax-exempt income resulting from the partial or complete forgiveness of a PPP Loan is treated as gross receipts under a particular Federal tax provision, including but not limited to §§ 448(c) and 6033 of the Code, section 3 of this revenue procedure applies for purposes of determining the timing and, to the extent relevant, reporting of such gross receipts.[614]

IRS Instructions

The Procedure provides an assurance that the IRS will provide instructions on how to report these items on 2021 returns, but taxpayers do not have to wait for the issuance of those 2021 instructions to begin using these procedures:

> The IRS will publish form instructions for the 2021 filing season that will detail how taxpayers can report consistently with sections 3.01 through 3.03 of this revenue procedure. However, taxpayers do not need to wait until the instructions are published to apply this revenue procedure.[615]

Partnerships

Revenue Procedure 2021-49,[616] issued at the same time as Revenue Procedure 2021-48, provides guidance for partnerships regarding allocation of amounts excluded from gross income and deductions relating to PPP loan programs and certain other COVID relief programs. Specifically, the Procedure applies to:

- A partnership that
  - Received a PPP Loan; and
  - Received partial or complete forgiveness of the PPP Loan such that, in accordance with § 7A(i) of the Small Business Act, or §§ 276(b) or 278(a)(1) of the COVID Tax Relief Act, as applicable, the forgiveness amount is not included in the gross income of the eligible recipient, entity, or borrower.

[613] Revenue Procedure 2021-48, November 18, 2021
[614] Revenue Procedure 2021-48, November 18, 2021
[615] Revenue Procedure 2021-48, November 18, 2021
[616] Revenue Procedure 2021-49, November 18, 2021

- A partnership for which the SBA made payments with respect to a covered loan under § 1112(c) of the CARES Act.

- A partnership that received an Emergency EIDL Grant, a Targeted EIDL Advance, or a Shuttered Venue Operator Grant.

- A partnership that received a Supplemental Targeted EIDL Advance.

- A partnership that received a Restaurant Revitalization Grant.[617]

The Procedure provides the following protection for partnerships that follow this procedure:

> If a Covered Taxpayer that is a partnership satisfies all of the applicable requirements provided in section 4.02 of this revenue procedure, and complies with all information reporting requirements described in section 6 of this revenue procedure, the Internal Revenue Service (IRS) will treat the Covered Taxpayer's allocation of amounts treated as tax exempt income and allocation of deductions described in section 4.02(1), (2), (3), or (4) of this revenue procedure (as the case may be) as determined in accordance with § 704(b) of the Code. Under § 705(a) of the Code, a partner's basis in its interest is increased by the partner's distributive share of tax exempt income and is decreased by the partner's distributive share of deductions described in section 4.02(1), (2), (3), or (4) of this revenue procedure.[618]

PPP Loans

A qualifying partnership will satisfy the requirements of this Procedure with regard to PPP loans if all of the following conditions are met:

- The allocation of deductions resulting from expenditures giving rise to the forgiveness of a PPP Loan is determined under § 1.704-1(b)(3), according to the partners' overall economic interests in the partnership.

- The allocation of amounts treated as tax exempt income under § 7A(i) of the Small Business Act, § 276(b) of the COVID Tax Relief Act, or § 278(a) of the COVID Tax Relief Act, as applicable, is made in accordance with the allocation of the deductions described in section 4.02(1)(a) of this revenue procedure.

- If any expenditure giving rise to the forgiveness of a PPP Loan is required to be capitalized under the Code (capitalized expenditure), the allocation of amounts treated as tax exempt income under § 7A(i) of the Small Business Act, § 276(b) of the COVID Tax Relief Act, or § 278(a) of the COVID Tax Relief Act, as

[617] Revenue Procedure 2021-49, November 18, 2021
[618] Revenue Procedure 2021-49, November 18, 2021

applicable, is made in accordance with the allocation of the deemed loss, as provided in this section 4.02(1)(c), with respect to the capitalized expenditure's basis. Solely for purposes of this revenue procedure, the deemed loss with respect to the capitalized expenditure's basis is treated as a loss allowable as a deduction and is equal to the amount of loss that would be recognized if the property to which the capitalized expenditure relates were treated as disposed of in a fully taxable transaction for no consideration (hypothetical transaction) and, with respect to each partner, the allocation of the deemed loss associated with the capitalized expenditure's basis is determined under § 1.704-1(b)(3), according to the partners' overall economic interests in the partnership. The hypothetical transaction and resulting deemed loss are solely for purposes of determining the manner in which tax exempt income described in this section 4.02(1)(c) is allocated to the partnership's partners.[619]

Payments Made by the SBA for Covered Loans

A qualifying partnership will satisfy the requirements of this Procedure with regard to payments made by the SBA on applicable loans if all of the following conditions are met:

- The allocation of deductions resulting from payments of interest and fees described in § 1112(c) of the CARES Act is determined under § 1.704-1(b)(3), according to the partners' overall economic interests in the partnership.

- The allocation of amounts treated as tax exempt income under § 278(c) of the COVID Tax Relief Act attributable to interest and fees described in § 1112(c) of the CARES Act is made in accordance with the allocation of the deductions described in section 4.02(2)(a) of this revenue procedure.

- The allocation of amounts treated as tax exempt income under § 278(c) of the COVID Tax Relief Act attributable to payments of principal described in § 1112(c) of the CARES Act is made in accordance with each partner's share of the liability under § 752 of the Code and the regulations thereunder.

- If any expenditure related to the payment of interest and fees described in §1112(c) of the CARES Act is required to be treated as a capitalized expenditure, the allocation of amounts treated as tax exempt income under § 278(c) of the COVID Tax Relief Act is made in accordance with the allocation of the deemed loss, as described in section 4.02(1)(c) of this revenue procedure, with respect to the capitalized expenditure's basis. Upon the hypothetical transaction, the allocation of the deemed loss is determined under § 1.704-(1)(b)(3), according to the partners' overall economic interests in the partnership. The hypothetical transaction and resulting deemed loss are solely for purposes of determining the manner in which

[619] Revenue Procedure 2021-49, November 18, 2021

tax exempt income described in this section 4.02(2)(d) is allocated to the partnership's partners.[620]

Emergency EIDL Grant, Targeted EIDL Advance, or a Shuttered Venue Operator Grant

A qualifying partnership will satisfy the requirements of this Procedure with regard to Emergency EIDL Grants, Targeted EIDL Advances, or Shuttered Venue Operator Grants if all of the following conditions are met:

- The allocation of deductions resulting from the expenditure of proceeds of an Emergency EIDL Grant, a Targeted EIDL Advance, or a Shuttered Venue Operator Grant is determined under § 1.704-1(b)(3), according to the partners' overall economic interests in the partnership.
- The allocation of amounts treated as tax exempt income under § 278(b) and (d) of the COVID Tax Relief Act is made in accordance with the allocation of the deductions described in section 4.02(3)(a) of this revenue procedure.
- If any expenditure paid with the proceeds from an Emergency EIDL Grant, a Targeted EIDL Advance, or a Shuttered Venue Operator Grant is required to be treated as a capitalized expenditure, the allocation of amounts treated as tax exempt income under § 278(b) and (d) of the COVID Tax Relief Act is made in accordance with the allocation of the deemed loss, as described in section 4.02(1)(c) of this revenue procedure, with respect to the capitalized expenditure's basis. Upon the hypothetical transaction, the allocation of the deemed loss is determined under § 1.704-(1)(b)(3), according to the partners' overall economic interests in the partnership. The hypothetical transaction and resulting deemed loss are solely for purposes of determining the manner in which tax exempt income described in this section 4.02(3)(c) is allocated to the partnership's partners.

Supplemental Targeted EIDL Advance or a Restaurant Revitalization Grant

A qualifying partnership will satisfy the requirements of this Procedure with regard to a Supplemental Targeted EIDL Advance or a Restaurant Revitalization Grant if all of the following conditions are met:

- The allocation of deductions resulting from the expenditure of proceeds of a Supplemental Targeted EIDL Advance or a Restaurant Revitalization Grant is determined under § 1.704-1(b)(3), according to the partners' overall economic interests in the partnership.
- The allocation of amounts treated as tax exempt income under §§ 9672 and 9673 of the ARP is made in accordance with the allocation of the deductions described in section 4.02(4)(a) of this revenue procedure.

[620] Revenue Procedure 2021-49, November 18, 2021

- If any expenditure paid with the proceeds from a Supplemental Targeted EIDL Advance or a Restaurant Revitalization Grant is required to be treated as a capitalized expenditure, the allocation of amounts treated as tax exempt income under §§ 9672 and 9673 of the ARP is made in accordance with the allocation of the deemed loss, as described in section 4.02(1)(c) of this revenue procedure, with respect to the capitalized expenditure's basis. Upon the hypothetical transaction, the allocation of the deemed loss is determined under § 1.704-(1)(b)(3), according to the partners' overall economic interests in the partnership. The hypothetical transaction and resulting deemed loss are solely for purposes of determining the manner in which tax exempt income described in this section 4.02(4)(c) is allocated to the partnership's partners.

Reporting Requirements

Revenue Procedure 2021-49 concludes by providing:

> A Covered Taxpayer that is a partnership must report to the IRS all partnership items described in section 4 of this revenue procedure that the Commissioner of Internal Revenue or the Commissioner's delegate may require in forms, instructions, or other guidance.[621]

Consolidated Groups

Revenue Procedure 2021-49 provides the following information for consolidated groups with regard to such COVID-related income exclusions:

> With regard to a Covered Taxpayer that is a member of a consolidated group, the IRS will treat any amount excluded from gross income under § 7A(i) of the Small Business Act, § 276(b) of the COVID Tax Relief Act, or § 278(a)(1) of the COVID Tax Relief Act, as applicable, as tax exempt income for purposes of § 1.1502-32(b)(2)(ii). A Covered Taxpayer that is a member of a consolidated group may rely on the IRS treatment provided by this section 5 only if the consolidated group attaches a signed statement to its consolidated tax return indicating that all Covered Taxpayers in the consolidated group are relying on this section 5 and reporting consistently.[622]

Amended Returns

The Revenue Procedure 2021-48 provides the following information about amended tax returns related to these timing issues for recognizing PPP loan forgiveness:

> Taxpayers may report tax-exempt income pursuant to section 3.01 on a timely filed original or amended Federal income tax return,

[621] Revenue Procedure 2021-49, November 18, 2021

[622] Revenue Procedure 2021-49, November 18, 2021

> information return or administrative adjustment request (AAR) under § 6227 of the Code.[623]

However, the Procedure notes that the IRS, at the same time as releasing Revenue Procedure 2021-48, also released Revenue Procedure 2021-50 which provides optional relief from the BBA Partnership Audit rules that would otherwise mandate the use of an AAR for a partnership that had not opted out of the BBA regime on their original returns:

> See also Revenue Procedure 2021-50, 2021-49 I.R.B. ___, released November 18, 2021, allowing an eligible partnership to file an amended Form 1065, *U.S. Return of Partnership Income*, as an alternative to filing an AAR, and furnish a corresponding amended Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc., to each of its partners. Partners and shareholders that receive amended Forms K-1 as provided in this section 3.02 must file amended Federal income tax returns, information returns or AARs, as applicable, consistent with the Forms K-1 received.[624]

Revenue Procedure 2021-50 provides the following option to file an amended return in lieu of an AAR request for a qualifying BBA partnership (note the very short time period to file this amended return):

> BBA partnerships that filed a Form 1065 and furnished all required Schedules K-1 for taxable years ending after March 27, 2020 and did so prior to the issuance of this revenue procedure may file amended partnership returns and furnish corresponding amended Schedules K-1 on or before *December 31, 2021(emphasis added)*. The amended returns must take into account tax changes under Rev. Proc. 2021-48 or Rev. Proc. 2021-49, but eligible BBA partnerships under section 3.03 of this revenue procedure may make any additional changes on their amended returns.[625]

These special rules are available only to BBA partnerships that filed Forms 1065 and furnished Schedules K-1 for the partnership taxable years ending after March 27, 2020 and prior to the issuance of Rev. Proc. 2021-48 or Rev. Proc. 2021-49 (November 18, 2021).

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[623] Revenue Procedure 2021-48, November 18, 2021
[624] Revenue Procedure 2021-48, November 18, 2021
[625] Revenue Procedure 2021-50, November 18, 2021, https://www.taxnotes.com/research/federal/irs-guidance/revenue-procedures/partnerships-pursuing-ppp-loan-forgiveness-benefits-may-amend-returns/7cm9q

Additionally, to be eligible for the amended return filing and furnishing option, BBA partnerships must:

- Be within the scope of section 3 of Rev. Proc. 2021-49 and meet the requirements of section 4.02(1), 4.02(2), 4.02(3), or 4.02(4) of Rev. Proc. 2021-49 by filing an amended Form 1065 in accordance with procedures in section 6 of Rev. Proc. 2021-49, or

- Treat tax-exempt income resulting from the forgiveness of a PPP Loan, at a time described in section 3.01(1), (2) or (3) of Rev. Proc. 2021-48 by filing an amended Form 1065 in accordance with procedures in section 3.02 of Rev. Proc. 2021-48, as applicable.[626]

The Procedure provides that, for purposes of the partner consistent reporting rules for BBA partnerships found at IRC §6222, "the amended return replaces any prior return (including any AAR filed by the partnership) for the taxable year for purposes of determining the partnership's treatment of partnership-related items."

Eligible tax years for this special amended return procedure are "any partnership taxable year ending after March 27, 2020 and prior to the issuance of Rev. Proc. 2021-48 and Rev. Proc. 2021-49."[627]

Filing an Amended Return in Lieu of an AAR

The Procedure provides the following method for filing amended returns in lieu of AARs for these purposes:

> To take advantage of the option to file an amended return provided by section 3 of this revenue procedure, a BBA partnership must file a Form 1065 (with the "Amended Return" box checked) and furnish corresponding amended Schedules K-1 to its partners. The BBA partnership must clearly indicate the application of this revenue procedure on the amended return and write "FILED PURSUANT TO REV PROC 2021-50" at the top of the amended return and attach a statement with each amended Schedule K-1 furnished to its partners with the same notation. The BBA partnership may file electronically or by mail but filing electronically may allow for faster processing of the amended return. The BBA partnership filing an amended return pursuant to this revenue procedure should not include any forms that are normally only filed with an AAR, such as Form 8985, *Pass-Through Statement-Transmittal/Partnership Adjustment Tracking Report (Required Under Sections 6226 and 6227)* or Form

[626] Revenue Procedure 2021-50, November 18, 2021
[627] Revenue Procedure 2021-50, November 18, 2021

> 8986, *Partner's Share of Adjustment(s) to Partnership-Related Item(s) (Required Under Sections 6226 and 6227).*[628]

If the BBA partnership's returns are under examination, the following provision applies:

> If a BBA partnership is currently under examination for a taxable year ending after March 27, 2020, and wishes to take advantage of the option to file an amended return provided by section 3 of this revenue procedure, the partnership may only do so if the partnership sends notice in writing to the revenue agent coordinating the partnership's examination that the partnership seeks to use the amended return option described in this revenue procedure prior to or contemporaneously with filing the amended return as described in section 4.01 of this revenue procedure. The partnership must also provide the revenue agent with a copy of the amended return and amended Schedules K-1 upon filing.[629]

If the BBA partnership has previously filed an AAR for the same taxable year, the following guidance applies:

> If a BBA partnership has previously filed an AAR and wishes to file an amended return pursuant to this revenue procedure for the same taxable year, the partnership should use the items as adjusted in the AAR, where applicable, in lieu of any reporting from the originally filed partnership return.[630]

If a passthrough-partner of the partnership filing an amended return in lieu of an AAR is itself also a BBA partnership, that partner can also file an amended return in lieu of an AAR but only for items included on the revised K-1 it received using the same procedures. The time limit to file an amended return of December 31, 2021 does not apply to this flow-through partner. These same relief rules apply to BBA partnerships that received an amended Schedule K-1 under any other previously issued revenue procedure allowing BBA partnerships to issue amended Schedules K-1.[631]

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[628] Revenue Procedure 2021-50, November 18, 2021
[629] Revenue Procedure 2021-50, November 18, 2021
[630] Revenue Procedure 2021-50, November 18, 2021
[631] Revenue Procedure 2021-50, November 18, 2021

SECTION: 461
GUARANTEED MINIMUM SALES INCENTIVE PROGRAM DID NOT ESTABLISH FACT OF A LIABILITY UNTIL DEALERS MADE SALES IN FOLLOWING YEAR

Citation: TAM 202121010, 5/28/21

In a Technical Advice Memorandum[632] the IRS ruled that an overall accrual basis corporation's promise to pay minimum incentives to dealers in the following year did not meet the requirements of the all events test under IRC §461, and thus could only be deducted in the year when the dealers sold the products in question.

Facts of the Program in Question

The TAM provides the following description of the program in question:

> To encourage sales of A to retail customers, Taxpayer offers a sales incentive program to B and to retail customers. This advice concerns the sale incentives offered to B. Under its sales incentives program, Taxpayers offers a variety of retail sales incentives to B and retail customers (e.g., bonuses, rebates, etc.). The rules and guidelines of these programs are outlined in a document called the C. The rules require that B must satisfy certain conditions before Taxpayer is obligated to make an incentive payment. The sales incentive program is communicated in the form of E and is offered throughout the year. However, it is only those sales incentives earned by B that were in B's ending inventory as of Date1 of Year 1 and sold by B between Date2 of Year 2 ("the qualifying period") that is relevant for this discussion.
>
> In Year 1, Taxpayer introduced the D in order to encourage additional purchases of A. Under the D, Taxpayer makes an irrevocable promise, to pay participating B an allocated share of a guaranteed minimum sales incentive payment if B sell A during the qualifying period, which is sales of A that was in B's ending inventory as of Date1 of Year 1 between Date2 of Year 2. Moreover, the promise to make the guaranteed minimum sales incentive payment under the D takes effect only if the participating B, in the aggregate, do not earn sales incentive payments during the qualifying period equaling at least the guaranteed minimum amount promised under the D.

[632] TAM 202121010, May 28, 2021, https://www.taxnotes.com/research/federal/irs-private-rulings/letter-rulings-%26-technical-advice/promise-to-pay-minimum-sales-incentive-doesn%e2%80%99t-accelerate-liability/67zrc (retrieved May 28, 2021)

> To earn the incentive B must sell A during the qualifying period, and to be eligible to share in the D, B must sell A during the qualifying period.
>
> Taxpayer effectuates the D by posting two short announcement letters — one addressed to each of the respective B divisions — to a B portal website that guarantees that participating B will have the opportunity to earn a minimum sales incentive payment in the following year. Taxpayer usually posts the letters for the D near the end of the fiscal year-end. Although the letters indicate that Taxpayer will provide additional details about the D, which include how the individual incentives will be calculated and a mechanism to allocate the guaranteed minimum payment among the B at a later date, Taxpayer has never published any additional details or information about the D other than the letters issued a few days before year-end.
>
> For every taxable year of the D, Taxpayer set the guaranteed minimum payment amount to be "somewhat below" the total incentive payments Taxpayer expected to pay B pursuant to C for the qualifying period. In effect, Taxpayer did not develop a mechanism to allocate the guaranteed minimum payment among the B for any of the taxable years at issue because the participating B always qualified to receive sales incentive payments in excess of the guaranteed amount promised under the D.
>
> Also, for the taxable years at issue for the D, there is no evidence indicating that participating B relied upon the announcement letters to purchase any additional A prior to the fiscal year-end announcement period. Taxpayer was unable to confirm or track whether any participating B opened or viewed the D announcement letters and Taxpayer received no inquiries or communication from B regarding the D announcement letters.[633]

Positions of the Taxpayer and the IRS Examination Team

Based on the promised minimum incentive payments under the program, the taxpayer took the following positions on tax returns for the years in question:

> For the taxable years at issue, Taxpayer has been treating the amount of the guaranteed minimum payment as a reduction to its gross receipts in the taxable year Taxpayer issues the D announcement letters. For sales incentive payments earned by B outside of the qualifying period (which is shorter than a year) and thus not covered

[633] TAM 202121010, May 28, 2021

> by the D, Taxpayer deducts the sales incentive payments earned by B when Taxpayer pays or credits B.[634]

In the exam, the IRS is proposing to deny these deductions in the year claimed, and pushing them back into the years that the dealer is required to sell the product:

> For the taxable years at issue, the IRS field office has proposed disallowing Taxpayer's reduction to its gross receipts for Year 1 for the amount of the guaranteed minimum payment promised under the D announcement letters because all events have not occurred to establish the fact of this liability in Year 1.[635]

A request for technical advice was raised to obtain a ruling on which treatment, if either, was proper for this program and the timing of the deduction.

The All Events Test

The TAM begins by discussing the all events test that applies to accrual basis taxpayers under IRC §461. The memorandum notes that under IRC §461(h) and Reg. §1.461-1(a)(2)(i), a deduction is taken into account by an accrual basis taxpayer in the taxable year when

- All events have occurred that establish the fact of the liability,
- The amount of the liability can be determined with reasonable accuracy, and
- Economic performance has occurred with respect to the liability.[636]

The memorandum discusses special details that impact the economic performance test:

> Section 1.461-4(g)(3) provides that if the liability of the taxpayer is to pay a rebate, refund, or similar payment to another person (whether paid in property, money, or as a reduction in the price of goods to be provided in the future by the taxpayer), economic performance occurs as payment is made to the person to which the liability is owed. This provision applies to all rebates, refunds, and payments or transfers in the nature of a rebate or refund regardless of whether they are characterized as a deduction from gross income, an adjustment to gross receipts or total sales, or an adjustment or addition to cost of goods sold.
>
> Section 1.461-5(b)(1) provides a recurring item exception to the general rule of economic performance. Under the recurring item

[634] TAM 202121010, May 28, 2021
[635] TAM 202121010, May 28, 2021
[636] TAM 202121010, May 28, 2021

exception, a liability is treated as incurred for a taxable year if: (i) at the end of the taxable year, all events have occurred that establish the fact of the liability and the amount can be determined with reasonable accuracy; (ii) economic performance occurs on or before the earlier of (a) the date that the taxpayer files a return (including extensions) for the taxable year, or (b) the 15th day of the 9th calendar month after the close of the taxable year; (iii) the liability is recurring in nature; (iv) either the amount of the liability is not material or accrual of the liability in the taxable year results in better matching of the liability against the income to which it relates than would result from accrual of the liability in the taxable year in which economic performance occurs. Section 1.461-5(b)(5)(ii) provides that, in the case of a liability for rebates, the matching requirement of the recurring item exception is deemed satisfied.[637]

Is the Liability Fixed as of the End of the First Year?

A key question is whether the liability is fixed as of the end of the first year in question. The memorandum takes a look at how, in the view of the author of the memorandum, case law has dealt with this issue.

> The first prong of the all events test requires that all events have occurred that establish the fact of the liability. Generally, all events occur to establish the fact of the liability when (1) the event fixing the liability, whether that be the required performance or other event, occurs, or (2) payment is unconditionally due. Rev. Rul. 2007-3, 2007-1 C.B. 350; Rev. Rul. 80-230, 1980-2 C.B. 169; Rev. Rul. 79-410, 1979-2 C.B. 213, amplified by Rev. Rul. 2003-90, 2003-2 C.B. 353.
>
> A taxpayer may not deduct a liability that is contingent, nor may a taxpayer deduct an estimate of an anticipated expense, no matter how statistically certain, if it is based on events that have not occurred by the close of the taxable year. *Brown v. Helvering*, 291 U.S. 193, 201 (1934). "The all events test is based on the existence or nonexistence of legal rights or obligations at the close of a particular accounting period, not on the probability — or even absolute certainty — that such right or obligation will arise at some point in the future." *Hallmark Cards, Inc. v. Commissioner*, 90 T.C. 26, 34 (1988). Even if that event is merely the arrival of a certain date. *Central Investment Corp. v. Commissioner*, 9 T.C. 128, 133 (1947), *affd. per curiam* 167 F.2d 1000 (9th Cir. 1948), *cert. denied* 335 U.S. 826 (1948).[638]

[637] TAM 202121010, May 28, 2021
[638] TAM 202121010, May 28, 2021

The memorandum notes that, as the taxpayer is invoking the recurring item exception, the only real issue is whether the fact of the liability is established as of year end:

> Taxpayer's liability is to pay a sales incentive to B which is in effect a rebate. Taxpayer pays the incentives during the first 8½ months of Year 2. Therefore, the economic performance requirement would be met if the liability were fixed at the end of Year 1. However, in order to apply the recurring item exception, all events must have occurred that establish the fact of the liability at issue, the guaranteed minimum amount promised under the D, in Year 1.[639]

The IRS, not surprisingly, often sees this standard not being satisfied when the taxpayer believes the existence of the liability is clearly fixed. The office handling the examination takes the following position regarding when the liability is fixed under this agreement:

> The IRS field office argues that Taxpayer's commitment to make the guaranteed minimum payment promised under the D is not required to be fulfilled unless and until B sells A that was in B's ending inventory as of Date 1 of Year 1 between Date2 of Year 2. Also, the IRS field office argues that Taxpayer's commitment to make the guaranteed minimum payment promised under the D is contingent upon participating B, in the aggregate, not earning sales incentives during the qualifying period in the following year equaling at least the guaranteed minimum amount promised under the D.[640]

The taxpayer claims that the program clearly fixes the liability prior to the end of the first year, rather than not being fixed until product is sold by the dealer in Year 2:

> Taxpayer argues that its liability to pay the guaranteed minimum payment under the D is fixed and determinable for purposes of § 461 in Year 1 when it issues the D announcement letters because its situation is indistinguishable from *United States v. Hughes Properties, Inc.*, 476 U.S. 593 (1986). In *Hughes Properties*, the Supreme Court allowed a Nevada casino operator to deduct amounts guaranteed for payment of progressive slot machine jackpots that had not yet been won by casino patrons. The Court found that the last event that created the casino's liability was the last play of a slot machine before the end of the fiscal year. At that point, Nevada law made the amount shown on the jackpot payoff indicators incapable of being reduced and, moreover, the Court found "[t]he effect of Nevada's law was the equivalent to the situation where state law requires the amounts of the jackpot indicators to be set aside in escrow pending the ascertainment or the identity of the winners." *Hughes Properties*, 476 U.S. at 602.

[639] TAM 202121010, May 28, 2021
[640] TAM 202121010, May 28, 2021

> Further, the Court noted that "[t]he obligation is there, and whether it turns out that the winner is one patron, or another makes no conceivable difference as to basic liability." *Id*.
>
> According to Taxpayer, Taxpayer was under a fixed obligation to pay the guaranteed minimum payment under the D at the end of its Year 1, even though it is based on when B sells A during the qualifying period, which occurs in Year 2. Taxpayer argues that the event triggering Taxpayer's obligation pay the guaranteed minimum payment under the D, which is when B sells A during the qualifying period in tax Year 2, was no different than when a patron wins a jackpot in the year following the taxable year in which the casino was allowed a deduction for the jackpot amount in *Hughes Properties*. Taxpayer adds that the event triggering Taxpayer's obligation to pay the guaranteed minimum payment under the D, which is when B sells A during the qualifying period in tax Year 2, was inevitable and that the Court in *Hughes Properties* held that a liability incurred by a taxpayer at the end of a taxable year is deductible in that taxable year if payment of the liability was inevitable even though some act remained to be completed in the following taxable year.[641]

The memorandum sides with the IRS examining office position on this issue:

> We agree with the field that these are conditions precedent that are necessary to establish Taxpayer's liability for purposes of § 461. Since the last event necessary to establish Taxpayer's liability occurs in Year 2, Taxpayer cannot establish the fact of its liability in Year 1. Thus, since Taxpayer may not treat the liability as incurred in tax Year 1 when it issues the commitment letter to make the guaranteed minimum payment under the D, the liability does not meet the requirements of the recurring item exception at that point.[642]

The memorandum rejected the taxpayers' arguments to the contrary, distinguishing the facts in this case from those in *Hughes Properties.*

> We disagree with Taxpayer's interpretation of *Hughes Properties* that its situation is analogous to *Hughes Properties*. In *Hughes Properties*, the last event necessary to establish the liability was the last play of the slot machine at year end because, even if the jackpot was not won with that play, Nevada law had the effect of irrevocably setting aside the amount of the jackpot by that play, which the casino eventually was required to pay. In Taxpayer's case, one of the two last events necessary to establish the liability was when B sells A during the qualifying period in Year 2. In short, in Taxpayer's case, the contingencies determine the existence

[641] TAM 202121010, May 28, 2021
[642] TAM 202121010, May 28, 2021

of the liability as of the end of tax Year 1, whereas in *Hughes Properties* the only contingencies relate to the identity of the winners of the jackpot.[643]

IRS and the Fact of a Liability

The decision is not terribly surprising, as the IRS does not much like the "payment is inevitable" position on the fact of the liability. The IRS concludes the memorandum by citing some other theories that might be used to attempt to defend the deduction that the agency seeks to distinguish.

Of particular interest, the IRS distinguishes the situation from that found in Rev. Rul. 2011-29:

> … Taxpayer's situation is distinguishable from Rev. Rul. 2011-29, 2011-49 I.R.B. 824. In Rev. Rul. 2011-29, the Service concluded that a taxpayer had established the fact of its liability, by the end of a taxable year, for a minimum amount of bonuses payable to a group of eligible employees in the following year even though the identity of the particular employees to which the bonuses will be paid was unknown until after the end of the taxable year. The Service noted the fact of the taxpayer's liability for the minimum amount of bonuses is established by the end of the year in which the services are rendered by the employees. See Rev. Rul. 54-446, 1955-2 C.B. 531, as modified by Rev. Rul. 61-127, 1961-2 C.B. 36 (holding that bonuses payable to ascertainable employees under an incentive compensation plan that has been communicated to the employees, the exact amounts of which are determinable through a formula in effect prior to the end of the taxable year, are properly accruable for Federal income tax purposes for the year to which they relate). Unlike Rev. Rul. 2011-29, in Taxpayer's case, Taxpayer promise to pay the guaranteed minimum payment under the D is not unconditionally fixed by the end of tax Year 1 because participating B have not rendered any services or provided any other consideration to Taxpayer by the end of tax Year 1 which would unconditionally require Taxpayer to pay the guaranteed minimum payment under the D. Taxpayer's promise to pay the guaranteed minimum payment under the D becomes unconditionally fixed when participating B sells A during the qualifying period in Year 2 and when participating B do not earn sales incentives during the qualifying period equaling at least the guaranteed minimum amount promised under the D, which can only be determined in Year 2.[644]

[643] TAM 202121010, May 28, 2021

[644] TAM 202121010, May 28, 2021

That 2011 Revenue Ruling is particularly interesting, as it represented the IRS's tacit acceptance, after years of questioning the logic of, a decision the agency lost in 1969 that affected tax years 1957, 1958 and 1959 (*Washington Post Co*[645]. *v. United States,* 405 F.2d 1279).

The IRS cited the *Post* case in the ruling, even though the IRS had, until then, announced it would not follow the *Post* case (Rev. Rul. 76-345, revoked by Revenue Ruling 2011-29). So it only took the IRS 42 years after losing on the issue in court (and continuing to lose in later cases that cited the *Post* case) to grudgingly agree to that deduction. The key issue was that even though the Company could not determine exactly who would receive specific payments, the plan was such that the amounts in question *would* be paid out to someone. But the IRS fought that position for decades despite continuing losses.

In this case, a key distinguishing fact is that should the dealer sell none of the product in inventory at the end of the prior year by the due date, then the dealer would not receive any payment. Even though that is wildly improbable, the IRS nevertheless uses that highly unlikely event as introducing sufficient uncertainty to find the fact of the liability has not been established.

Thus, even though under generally accepted accounting principles it may seem clear that there is a liability, don't be surprised if the IRS disagrees if the agency can find any sort of future contingency. It may require going to court (or at least convincing the IRS the taxpayer will do that) to get that earlier deduction.

SECTION: 3131
EMPLOYER GUIDANCE ISSUED FOR REPORTING COVID SICK AND FAMILY LEAVE PAY ON 2021 W-2S

Citation: Notice 2021-53, 9/7/21

In Notice 2021-53[646] the IRS has issued guidance to employers for reporting qualified leave wages for 2021. The Notice serves to update the guidance provided for reporting such items on 2020 W-2s to take into account changes made in the qualified leave wage provisions for 2021.

General Reporting Requirements

The overall reporting requirements are described as follows by the Notice:

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[645] The Washington Post Co. was renamed in 2013 to Graham Holdings Company after the sale of the Washington Post newspaper in 2013 to Jeff Bezos. Graham Holdings Company is the corporate parent of Kaplan, Inc.

[646] Notice 2021-53, September 7, 2021, https://www.taxnotes.com/research/federal/irs-guidance/notices/guidance-prescribes-reporting-requirements-for-qualified-leave-wages/783k8 (retrieved September 10, 2021)

> In order to provide eligible self-employed individuals who also receive wages or compensation as employees with the information they need to properly claim any qualified sick leave equivalent or qualified family leave equivalent credits for the 2021 taxable year, this notice requires eligible employers to report to employees the amount of qualified sick leave wages and qualified family leave wages paid to the employees under (i) sections 7001 or 7003 of the Families First Act for leave provided during the period beginning January 1, 2021, through March 31, 2021, and (ii) sections 3131 and 3132 of the Code for leave provided during the period beginning April 1, 2021, through September 30, 2021. Furthermore, since qualified leave wages are defined under both the Families First Act and sections 3131 and 3132 of the Code as wages defined in section 3121(a) without regard to the exclusions from employment under section 3121(b)(1) through (22) and compensation defined in section 3231(e) without regard to the exclusions from compensation under section 3231(e)(1), eligible employers must determine the amount of qualified leave wages to report without regard to the exclusions from employment under section 3121(b)(1) through (22) and without regard to the exclusions from compensation under section 3231(e)(1).[647]

These special reporting rules are only required for employers that have claimed the credits involved—if the employer did not claim such credits, no extra reporting is required:

> Only eligible employers who claim credits under the Families First Act or sections 3131 and 3132 of the Code are required to separately report qualified sick leave wages and qualified family leave wages to their employees. Eligible employers who forego claiming refundable tax credits under the Families First Act or sections 3131 and 3132 of the Code for qualified leave wages are not required to separately report qualified sick leave wages or qualified family leave wages paid to employees to the extent those wages are not claimed as a credit. Furthermore, governmental employers that are prohibited from claiming credits for qualified leave wages are not required to separately report any qualified sick leave wages or qualified family leave wages paid to employees.[648]

Specific Reporting Instructions

Because of the differing rules that apply to the credit for different time periods in 2021, an employer must separately report:

[647] Notice 2021-53, September 7, 2021
[648] Notice 2021-53, September 7, 2021

- Leave provided to employees during the period beginning January 1, 2021, through March 31, 2021 (under the Families First Act as extended by the Comprehensive Appropriations Act, 2021); and

- Leave provided to employees during the period beginning April 1, 2021, through September 30, 2021, (under sections 3131and 3132 of the Code as provided by the American Rescue Plan Act of 2021).[649]

Employers have two options for this reporting:

> Employers must separately state each of these wage amounts either on the 2021 Form W-2, Box 14, or on a separate statement included with each employee's Form W-2, Wage and Tax Statement. Self-employed individuals claiming a credit for a qualified sick leave equivalent amount or qualified family leave equivalent amount must report these qualified sick leave wages and qualified family leave wages on Form 7202, Credits for Sick Leave and Family Leave for Certain Self-Employed Individuals, included with their 2021 income tax returns, and may have to reduce (but not below zero) any qualified sick leave or qualified family leave equivalent amounts by these qualified leave wages.[650]

The employer is required to report the following to the employee. Each item must be reported separately either in Box 14 or on a separate statement to each employee:

- The total amount of qualified sick leave wages paid for reasons described in paragraphs (1), (2), or (3) of section 5102(a) of the EPSLA with respect to leave provided to employees during the period beginning on January 1, 2021, through March 31, 2021. In labeling this amount, employers must use the following, or similar language: "sick leave wages subject to the $511 per day limit paid for leave taken after December 31, 2020, and before April 1, 2021."

- The total amount of qualified sick leave wages paid for reasons described in paragraphs (4), (5), or (6) of section 5102(a) of the EPSLA with respect to leave provided to employees during the period beginning on January 1, 2021, through March 31, 2021. In labeling this amount, employers must use the following, or similar language: "sick leave wages subject to the $200 per day limit paid for leave taken after December 31, 2020, and before April 1, 2021."

- The total amount of qualified family leave wages paid to the employee under the EFMLEA with respect to leave provided to employees during the period beginning on January 1, 2021, through March 31, 2021. In labeling this amount, employers must use the following or similar language: "emergency family leave wages paid for leave taken after December 31, 2020, and before April 1, 2021."

[649] Notice 2021-53, September 7, 2021
[650] Notice 2021-53, September 7, 2021

- The total amount of qualified sick leave wages paid for reasons described in paragraphs (1), (2), or (3) of section 5102(a) of the EPSLA with respect to leave provided to employees during the period beginning on April 1, 2021, through September 30, 2021. In labeling this amount, employers must use the following, or similar language: “sick leave wages subject to the $511 per day limit paid for leave taken after March 31, 2021, and before October 1, 2021.”

- The total amount of qualified sick leave wages paid for reasons described in paragraphs (4), (5), and (6) of section 5102(a) of the EPSLA with respect to leave provided to employees during the period beginning on April 1, 2021, through September 30, 2021. In labeling this amount, employers must use the following, or similar language: “sick leave wages subject to the $200 per day limit paid for leave taken after March 31, 2021, and before October 1, 2021.”

- The total amount of qualified family leave wages paid to the employee under the EFMLEA with respect to leave provided to employees during the period beginning on April 1, 2021, through September 30, 2021. In labeling this amount, employers must use the following or similar language: “emergency family leave wages paid for leave taken after March 31, 2021, and before October 1, 2021.”[651]

The following special rules apply to using a separate statement rather than reporting the amounts on Form W-2:

> If a separate statement is provided and the employee receives a paper Form W-2, then the statement must be included with the Form W-2 sent to the employee, and if the employee receives an electronic Form W-2, then the statement must be provided in the same manner and at the same time as the Form W-2.[652]

The Notice also provides the following requirements for an employer that erroneously reported such sick pay but did not (or was not eligible to) claim the credit:

> If an employer that does not claim credits under these provisions or an employer that is prohibited from claiming those credits erroneously reports sick leave wages or family leave wages to an employee on Form W-2, Box 14, or on a separate statement, the employer must either furnish a W-2c, Corrected Wage and Tax Statement, or provide a corrected statement to the employee correcting the erroneous reporting. The Form W-2c or corrected statement should be sent only to the employee. The employer should not file Form W-2c with the Social Security Administration solely to correct the amount in Box 14.[653]

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[651] Notice 2021-53, September 7, 2021
[652] Notice 2021-53, September 7, 2021
[653] Notice 2021-53, September 7, 2021

The employer must also provide an explanation of the implications of these amounts to the employee. The Notice states:

> As part of the Instructions for Employee, under the instructions for Box 14, for the Forms W-2, or in a separate statement sent to the employee, the employer may provide additional information about qualified sick leave wages and qualified family leave wages and explain that these wages may limit the amount of the qualified sick leave equivalent or qualified family leave equivalent credits to which the employee may be entitled with respect to any self-employment income. The following model language (modified as necessary) may be used. Please note that this language has been modified from that suggested in Notice 2020-54. (emphasis added)[654]

As that last sentence notes, it would be a mistake for employers to simply continue to use the employee instruction text the organization used for 2020 W-2s.

The model 2021 language is provided below:

> Included in Box 14, if applicable, are amounts paid to you as qualified sick leave wages or qualified family leave wages under the Families First Coronavirus Response Act and/or sections 3131 and 3132 of the Internal Revenue Code. Specifically, up to six types of paid qualified sick leave wages or qualified family leave wages may be reported in Box 14:
>
> Sick leave wages subject to the $511 per day limit paid for leave taken after December 31, 2020, and before April 1, 2021, because of care you required.
>
> Sick leave wages subject to the $200 per day limit paid for leave taken after December 31, 2020, and before April 1, 2021, because of care you provided to another.
>
> Emergency family leave wages paid for leave taken after December 31, 2020, and before April 1, 2021.
>
> Sick leave wages subject to the $511 per day limit paid for leave taken after March 31, 2021, and before October 1, 2021, because of care you required.
>
> Sick leave wages subject to the $200 per day limit paid for leave taken after March 31, 2021, and before October 1, 2021, because of care you provided to another.

[654] Notice 2021-53, September 7, 2021

Emergency family leave wages paid for leave taken after March 31, 2021, and before October 1, 2021.

If you have self-employment income in addition to wages paid by your employer, and you intend to claim any qualified sick leave or qualified family leave equivalent credits, you must report the qualified sick leave or qualified family leave wages on Form 7202, Credits for Sick Leave and Family Leave for Certain Self-Employed Individuals, included with your income tax return, and may have to reduce (but not below zero) any qualified sick leave or qualified family leave equivalent credits by the amount of these qualified leave wages. If you have self-employment income, you should refer to the instructions for your individual income tax return for more information.[655]

SECTION: 6656
PMTA ARGUES THAT TAXPAYERS WHO MAKE MINOR ERRORS IN DEPOSITING DEFERRED FICA UNDER CARES ACT TIMELY OWE PENALTY ON ENTIRE AMOUNT DEFERRED

Citation: PMTA 2021-007, 8/23/21

The IRS issued PMTA 2021-07[656] that addresses a problem taxpayers who deferred employer FICA under the CARES Act may run into this year or next—with a consequence far more negative than they would believe would happen for what to them appears to be a minor error.

The question to be answered by this PMTA is the following:

> If any portion of an employer's section 3111(a) (employer portion of social security) taxes or so much of the taxes imposed under section 3221(a) as are attributable to the rate in effect under section 3111(a), the payment and deposit due dates of which are deferred under CARES Act section 2302, is not deposited by the applicable installment due date, is the deferral of the deposit due date invalidated for all of the employer's deferred section 3111(a) or 3221(a) tax, rather than just the remaining delinquent portion? Is the result that the section 6656 penalty for failure to deposit taxes is applicable to the entire deferred amount, assuming that no exception to the penalty applies?[657]

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655 Notice 2021-53, September 7, 2021

656 PMTA 2021-07, August 23, 2021, https://www.irs.gov/pub/lanoa/pmta-2021-07.pdf (retrieved August 24, 2021)

657 PMTA 2021-07, August 23, 2021

The answer to this question may come as a major (and not positive) surprise to those who took advantage of this deferral:

> Yes to both questions. CARES Act section 2302(a)(2) conditions the deferral of deposits on the timely deposit of all amounts deferred by the applicable due dates of December 31, 2021 and December 31, 2022.2 For example, if an employer defers the deposit of its portion of the section 3111(a) tax (the employer's portion of social security tax) in the amount of $50,000, and deposits and pays $25,000 on December 31, 2021 but fails to make any additional deposits or payments by December 31, 2022, the employer is liable for a section 6656 penalty on the entire $50,000 if no exception to the penalty applies.

Since the penalty under IRC §6656 for failure to timely deposit payroll taxes that are paid more than 15 days after the date due is 10% of the amount due, a penalty equal to 10% of the *total amount deferred* would be due if the taxpayer makes a minor error in getting the proper amount deposited by December 31, 2021, *or* December 31, 2022.

The PMTA points out the details of the deferral provision that was found in the CARES Act as follows:

> Section 2302(a)(1) of the CARES Act changes the due date for the payment of certain employment taxes to the applicable date defined later in the statute. Section 2302(a)(2) provides that deposits of those taxes will not be treated as due on the dates required by Treas. Regs. §§ 31.6302-1 and 31.6302-2, if certain conditions are met. Specifically, CARES Act section 2302(a)(2) provides that:
>
> Notwithstanding section 6302 of the Internal Revenue Code of 1986, an employer shall be treated as having timely made all deposits of applicable employment taxes that are required to be made (without regard to this section) for such taxes during the payroll tax deferral period if all such deposits are made not later than the applicable date.[658]

The *applicable date* is defined as follows as noted by the PMTA:

> The term "applicable date" means December 31, 2021, with respect to 50% of the eligible deferred amount of tax deferred under CARES Act section 2302(a); and December 31, 2022, with respect to the remaining tax so deferred. CARES Act § 2302(d)(3). If an employer pays any amount before the applicable dates, any such payment is first applied to reduce the employer's liability for an amount due on

[658] PMTA 2021-07, August 23, 2021

> December 31, 2021 and then to the amount due on December 31, 2022.[659]

The PMTA summarizes the rules as follows:

> In other words, CARES Act section 2302(a)(2) allows an employer to defer, without incurring a penalty under section 6656, its deposits of the applicable employment taxes until December 31, 2021 and December 31, 2022, provided that the conditions stated in CARES Act section 2302(a)(2) are satisfied.[660]

But the problem is that the provision conditions allowing for the late deposit on the entire deferred amount only if the required payments are made timely and in at least the amounts required:

> CARES Act section 2302(a)(2) conditions the deferral of deposits on the deposit of all deferred amounts by the applicable installment due dates. Specifically, the deferral of the deposits is valid provided "all such deposits are made not later than the applicable date."[661]

Thus, any failure to make at least the cumulative amount of the payments due by the appropriate December 31 deadline triggers a penalty on the *entire amount deferred* with the due date of the deposit going back to the date the taxes originally would have been due in 2020 or very early in 2021 (more than 15 days before either December 31, 2021, or December 31, 2022):

> If any portion of the deposit is not made by the applicable date, whether December 31, 2021, as to the first installment, or December 31, 2022, as to the second installment, then the deferral is completely invalid. In that event, the deposits were due on the usual deposit due dates provided in Treas. Regs. §§ 31.6302-1 and 31.6302-2, which would be the due dates used in determining any penalties under section 6656.[662]

The IRS gives the following examples of the application of these penalties:

EXAMPLE ONE: INSUFFICIENT PAYMENT ON DECEMBER 31, 2021, PMTA 2021-007

Assume that an employer is liable for section 3111(a) tax, the employer's share of social security tax. Under CARES Act section 2302(a), these taxes are not due until the applicable due dates of December 31, 2021 and December 31, 2022. The employer is also required to

[659] PMTA 2021-07, August 23, 2021
[660] PMTA 2021-07, August 23, 2021
[661] PMTA 2021-07, August 23, 2021
[662] PMTA 2021-07, August 23, 2021

deposit these taxes by section 6302 and its implementing regulations. Assume that any failure to deposit is not due to reasonable cause, and no other exception is applicable. Additionally, assume that an employer has deferred, under CARES Act section 2302(a)(2), the deposit for the maximum amount of the employer's section 3111(a) tax for the 2020 tax year allowed to be deferred, and that this maximum amount deferred is a deposit of $50,000 of section 3111(a) taxes. As a result, under CARES Act section 2302(d)(3), the employer must deposit $25,000 by December 31, 2021, and the remaining $25,000 by December 31, 2022.

If, for the 2020 tax year, the employer deposits $5,000 on December 31, 2021, and makes no other deposits before December 31, 2021, the 10% penalty under section 6656(b)(1)(A)(iii), for failure to deposit tax for more than 15 days, applies to the entire $50,000, and the penalty amount would be $5,000. Because the first installment of $25,000, due on December 31, 2021, was not deposited by that date, the deferral is invalidated as to the entire $50,000. If, on February 7, 2022, the IRS issues a notice demanding payment of the balance of the first installment, and the employer does not pay the full amount demanded by February 17, 2022, the penalty rate increases to 15 percent.

EXAMPLE TWO: LATE PAYMENT FOR DECEMBER 31, 2022, PMTA 2021-007

Assume the same facts as in the first example, except that the first deposit of $25,000 was timely made on December 31, 2021.

If the employer deposits the remaining $25,000 on February 28, 2023, the 10% penalty under section 6656(b)(1)(A)(iii), for failure to deposit tax for more than 15 days, applies to the entire $50,000, and the penalty amount would be $5,000. Because the second installment of $25,000, due on December 31, 2022, was not timely deposited, the deferral is invalidated as to the entire $50,000. If, on February 6, 2023, the IRS issues a notice demanding payment of the second installment of $25,000, and the employer does not pay the full amount demanded by February 16, 2023, the penalty rate increases to 15 percent.

Note that in both cases, a full $5,000 penalty (10% of the total $50,000 deferred FICA taxes) is due assuming the payment is made before the date 10 days after the IRS issues a demand for payment—and if the payment isn't made until after that date, the penalty will grow to $7,500 (15% of $50,000).

While the taxpayers can argue for reasonable cause for failing to timely pay the balances due, advisers should probably begin to warn any clients that deferred the payroll taxes of the importance of making sure the deposits are made in the proper amount and on or before each due date. It is not likely a taxpayer stating "I forgot about the payment being due" is going to be deemed to have provided reasonable cause for failing to pay the taxes timely.

SECTION: STATE TAX
SUPREME COURT DECLINES TO HEAR CHALLENGE ON TAXING EMPLOYEES WHO WORKED REMOTELY OUT OF STATE DURING COVID-19 EMERGENCY

Citation: Supreme Court Order List: 594 US, Monday, June 28, 2021, New Hampshire *v.* Massachusetts, 6/28/21

The U.S. Supreme decided not to hear the challenge by the state of New Hampshire to Massachusetts' taxation of workers who worked remotely in other states.[663]

The state of Massachusetts issued emergency regulations on nonresident income sourcing due to the closing of offices in the state during the COVID-19 epidemic.[664] The key provision the state of New Hampshire objected to reads as follows:

> Under M.G.L. c. 62, § 5A(a), income of a nonresident derived from a trade or business, including any employment, carried on in the Commonwealth is sourced to Massachusetts. Pursuant to this rule, all compensation received for services performed by a nonresident who, immediately prior to the Massachusetts COVID-19 state of emergency was an employee engaged in performing such services in Massachusetts, and who is performing services from a location outside Massachusetts due to a Pandemic-related Circumstance will continue to be treated as Massachusetts source income subject to personal income tax under M.G.L. c. 62, § 5A and personal income tax withholding pursuant to M.G.L. c. 62B, § 2.[665]

In this case, this rule applied during the following time period:

> 830 CMR 62.5A.3 applies to the sourcing of wage income attributable to employee services performed commencing March 10, 2020 through 90 days after the date on which the Governor of the Commonwealth gives notice that the Massachusetts COVID-19 state of emergency is no longer in effect.[666]

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[663] Supreme Court Order List: 594 US, Monday, June 28, 2021, *New Hampshire v. Massachusetts*, p. 2, https://www.supremecourt.gov/orders/courtorders/062821zor_6j37.pdf (retrieved June 29, 2021)
[664] Massachusetts 830 CMR 62.5A.3, December 8, 2020, https://www.taxnotes.com/research/state/massachusetts/regulation/ma-admin-department0830%20cmr/massachusetts-830-cmr-830-cmr-62.00-v-1-62.5a.3-v-1 (retrieved June 29, 2021)
[665] Massachusetts 830 CMR 62.5A.3(3)(a)
[666] Massachusetts 830 CMR 62.5A.3(1)(d)

By the time the Supreme Court issued its ruling passing on hearing the case, the regulation was already on the path to expiring. As the State of Massachusetts noted in a supplemental brief filed on June 15:

> This supplemental brief, filed pursuant to Rule 15.8, brings to the Court's attention that on June 15, 2021, the Commonwealth of Massachusetts's COVID-19 state of emergency ended. See Governor Charles D. Baker, COVID-19 Order No. 69 (May 28, 2021), https://tinyurl.com/5ddx42bn (ending emergency effective June 15, 2021); see also Office of Governor Charlie Baker & Lt. Governor Karyn Polito, COVID-19 State of Emergency, https://tinyurl.com/fwwsbvkt (acknowledging emergency's end on June 15, 2021). The Governor's declaration of an end to the emergency triggers the sunset of the pandemic-related tax regulation New Hampshire seeks to challenge in this Court in the first instance. See 830 Code Mass. Regs. 62.5A.3(1)(d) (governing "the sourcing of wage income attributable to employee services performed commencing March 10, 2020 through 90 days after the date on which the Governor of the Commonwealth gives notice that the Massachusetts COVID-19 state of emergency is no longer in effect"); see also *id*. at 62.5A.1(5), 62.5A.2 (setting forth Massachusetts's pre-existing wage-income sourcing rules — not challenged by New Hampshire here — that will apply following the pandemic-related regulation's sunset).
>
> The regulation's sunset, while not unexpected in that it is contemplated by the regulation's very terms, underscores the arguments why this dispute fails to rise to the level of grave importance warranting exercise of the Court's original jurisdiction, see Br. in Opp. 11-21; U.S. Br. 4-11, and why any disputes over the application of the temporary regulation to taxpayers should be addressed through the ordinary course of state proceedings in the first instance, see Br. in Opp. 22-25; U.S. Br. 11-16. Above all, the development belies New Hampshire's contention that this expressly time-limited measure will endure "indefinitely," N.H. Reply Br. 2.[667]

Although the order did not contain any explanation of why the court decided 7-2 not to hear this case, a number of factors may have influenced the court's decision to pass on this case.

First, the Supreme Court rarely hears these cases between the states where it has original jurisdiction, even though two Justices (Justices Thomas and Alito) have argued the court is required to take up these cases. While those two Justices again wanted the Court to hear this case, the other Justices do not appear to share this view.

[667] Supplemental Brief in Opposition, Commonwealth of Massachusetts, June 15, 2021

Second, as Massachusetts noted, the regulation in question would not be in force by the time that any decision would be rendered. Of course, that overlooks the fact that those who were working outside the state and were covered by this rule would have had a claim for refund on amounts the Commonwealth taxed during the time this regulation was in place. As well, the lifting of the state of emergency occurred just days before this order was issued, so it doesn't appear likely that this was the key reason the Court passed on this case.

To this author, a reason suggested by Don Williamson, professor at the Kogod School of Business at American University and executive director of the Kogod Tax Policy Center in an article on the denial published in *Tax Notes Today Federal*[668] on June 29 that the court saw this as a case that individuals (not the state) should first litigate before SCOTUS would consider looking at the issue seems a more likely reason for the Court to pass on taking on the case:

> Williamson said requiring the affected taxpayers to sue in the Massachusetts courts would provide a record, and the Court could more easily make a decision instead of exercising original jurisdiction and having to start from scratch.
>
> …
>
> "As the Supreme Court does, and probably should, they'll only take up an issue when they have to, and they didn't have to take this issue up today," Williamson said, suggesting that there may eventually be a better case for the Court to take up and address those issues.[669]

Certainly, the failure of the Court to take up this case doesn't mean they necessarily agree with Massachusetts on the merits of their position.

However, some advisors had hoped the Court might take up this case and deal with the broader concept of states that have "convenience of the employer" sourcing rules, such as the state of New York. Such rules generally source income to the state if the employee is providing services to an employer's location in the state and there is no reason an employer would require the employee to be in that other state had the employee not already been there.

[668] Andrea Muse, "SCOTUS Won't Hear New Hampshire Remote Worker Tax Fight," *Tax Notes Today Federal*, June 29, 2021, https://www.taxnotes.com/tax-notes-today-federal/nonresident-taxation/scotus-wont-hear-new-hampshire-remote-worker-tax-fight/2021/06/29/76pwf (subscription required, retrieved June 29, 2021)

[669] Andrea Muse, "SCOTUS Won't Hear New Hampshire Remote Worker Tax Fight," *Tax Notes Today Federal*, June 29, 2021

EXAMPLE—LOCATED OUT OF STATE FOR THE CONVENIENCE OF THE EMPLOYER

Mary has taken a job with Employer Co, located in State B to sell products for the company in State C, a state located on the opposite coast of the country from State B. State B sources wage income based on a convenience of the employer rule. Mary's job includes meeting with customers at their location, providing in-person training and being available to provide in-person assistance should the customers run into problems with Employer Co.'s products.

The nature of the position Employer Co. has hired Mary to fill requires Mary to be located in State C. Thus, she is located in State C for the convenience of Employer Co. and her wages are not considered by State B to be sourced to State B, therefore she owes no tax to State B.

EXAMPLE—NOT LOCATED OUT OF STATE FOR THE CONVENIENCE OF THE EMPLOYER

Let us assume Employer Co. is in the business of preparing tax returns in State B and Mary, again located in State C, is hired to perform tax preparation services. Employer Co.'s clients are primarily located in State B. Mary's job is solely to initially prepare returns based on information provided to her electronically by Employer Co. and Employer Co.'s clients. While Mary does phone these clients to ask questions, she does not meet with the clients in person, nor do others performing a similar job for Employer Co. who work out of the company's offices in State B.

In this case, Employer Co. has no requirement that Mary be located in State C, and her job could just as easily be done in State B where Employer Co. is located. In this case, Mary performing services in State C is not for the convenience of the employer, but rather for her own convenience.

While only a minority of states have a variant of the convenience of the employer rule (with most located in the Northeast), the COVID-19 pandemic and the rethinking of tax nexus brought about by the *Wayfair* decision may see more states looking at using this option, especially if remote work continues to grow and employees locate in lower-tax jurisdictions.

Unit 8

Passthrough Developments

LEARNING OBJECTIVES

When you have completed this unit, you will be able to

- **Properly prepare** tax returns including taxpayer basis and tax basis capital accounts based on recent IRS guidance
- **Obtain** a general understanding of key passthrough tax developments over the past year and apply them to specific taxpayer situations

SECTION: 61
AMOUNTS ADVANCED FROM ONE PARTNER WERE DEBTS OF THE PARTNERSHIP, OTHER PARTNERS HAD CANCELLATION OF INDEBTEDNESS INCOME

Citation: Michael Hohlet ux. et al. *v.* Commissioner, TC Memo 2021-5, 1/13/21

The partnership in the case of *Michael Hohlet ux. et al. v. Commissioner*, TC Memo 2021-5[670] attempted to claim that amounts it received from a partner it had treated in prior years as loans were actually capital contributions in the final year of the partnership. However, both the IRS and the Tax Court did not agree, finding that amount represented cancellation of indebtedness income in the final year of the partnership.

Three of the partners had contributed no funds to start the partnership, but were paid guaranteed payments each year. They each were treated as having a 30% interest. Eduardo Rodriguez put up $265,000 of cash for a 10% interest. In later years, Mr.

[670] *Michael Hohlet ux. et al. v. Commissioner*, TC Memo 2021-5, January 13, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/partners-received-income-from-discharge-of-partnership-debt/2drcj (retrieved January 15, 2021)

Rodriguez advanced the partnership money that was treated as loans to the partnership, money used for partnership operations.

The partnership lost money each year, with each of the partners who had contributed no cash or property to the partnership being allocated a portion of the debt from Mr. Rodriguez as recourse debt on their K-1, using that basis to claim their share of the losses.

The partnership ceased operations in 2012. As the opinion describes the facts:

> Echo's 2012 Form 1065 was marked as its final return. Echo reported no income, deductions, losses, or guaranteed payments. Echo's liability increased by $14,184, to $653,506, but unlike past years' liabilities the amount was recorded as "Loans from partners", not as "Other liabilities."
>
> The Schedules K-1 for 2012 reflected Echo's limited operations that year. Echo did not allocate any income, losses, deductions, or guaranteed payments to Mr. Hohl, Mr. Blake, or Mr. Bowles. Their Schedules K-1 each reported negative capital account balances, unchanged from 2011, of $178,210. Mr. Rodriguez' Schedule K-1 reported a negative capital account balance of $59,404, but no longer reported any share of partnership liabilities.
>
> …
>
> In summary, Echo's 2012 return showed a liability remaining on its balance sheet of $653,506, but no partner reported an allocation of any share of that liability. The partnership did not report any income, such as income from the discharge of indebtedness, nor did Echo allocate to any partner any share of any such income. Mr. Hohl and Mr. Blake reported no partnership income for 2012.[671]

The IRS had issues with this final return that simply left the unpaid liability by itself on the final balance sheet. For the two taxpayers in this case, the opinion notes:

> In each notice, the Commissioner adjusted the taxpayer's Schedule E income upward by $178,210, the amount of the partner's negative capital account balances, representing the partner's share of cancellation of indebtedness income. The explanation of the adjustment stated: "It is determined that your share of income from the partnership known as Echo Mobile Marketing for taxable year 2012 is $178,210.00 instead of $0.00 as reported on your return. Therefore, taxable income is increased $178,210.00 for tax year ended

[671] *Michael Hohlet ux. et al. v. Commissioner*, TC Memo 2021-5, pp. 7-8

> December 31, 2012." Each couple timely filed a petition with our Court.[672]

Since the IRS position was that there was cancellation of indebtedness income, the Tax Court first looked at whether the amounts advanced by Mr. Rodriguez were debts of the partnership or not. The taxpayers argued that Mr. Rodriguez had actually provided capital contributions.

The Court found that the amounts advanced were debts:

> We do not find credible petitioners' arguments that Mr. Rodriguez made capital contributions. While the absence of a written loan document might support petitioners as to the first factor, the partners clearly intended to treat, and did treat, the amounts received from Mr. Rodriguez as loans.
>
> Echo's partners' actions suggest that they considered Mr. Rodriguez's cash infusions to be loans. Echo reported the amounts as liabilities each year it operated. The Schedules K-1 Echo sent to its partners reported the amounts as liabilities every year and allocated a share of those liabilities to each partner in 2009. Mr. Hohl and Mr. Blake each filed individual returns accepting and benefiting from their characterization of these amounts as debt. If Mr. Rodriguez had made a capital contribution of $265,000 in 2009, paragraph 4.4 of the operating agreement would have required Mr. Rodriguez to include that contribution in his initial capital account balance. He did not do so. And according to the agreement, if the partnership needed additional capital contributions, Echo had to notify all partners in writing and give them an equal opportunity to contribute. We have no evidence of any such notices. The record also does not include any explanation as to why Mr. Rodriguez's ownership percentage did not change as a result of his supposed additional capital contributions. Mr. Rodriguez did not testify.
>
> As for the third factor, the record includes no evidence that Echo could not have obtained loans from third parties.
>
> The amounts Echo received from Mr. Rodriguez were loans.[673]

So now the question becomes if there was cancellation of debt income in 2012 or another year. The Court notes that the test for when such cancellation occurs is as follows:

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[672] *Michael Hohlet ux. et al. v. Commissioner*, TC Memo 2021-5, p. 8

[673] *Michael Hohlet ux. et al. v. Commissioner,* TC Memo 2021-5, pp. 11-12

> When a taxpayer realizes income from cancellation of indebtedness is a question of fact. Discharge of a debt occurs when it becomes clear that the debt will never be repaid. We look for "[a]ny 'identifiable event' which fixes the loss with certainty."[674]

The Tax Court determined that, in fact, 2012 was the year the cancellation of indebtedness took place:

> It became certain in 2012 that Echo would not repay its debt to Mr. Rodriguez, and thus Echo had income from the discharge of debt for that year. The partners testified that Echo would pay Mr. Rodriguez when the venture became profitable. When Echo ceased operations, it became clear it would never be profitable. Echo ceased operations when it filed its final return in 2012. Echo's termination in 2012 is when the debt became uncollectible.
>
> The Hohls and the Blakes argue that Echo ceased operations in 2011. But the partnership had ongoing activity in 2012, evidenced by Mr. Rodriguez's lending the partnership an additional $14,184 in that year. Echo, therefore, did not terminate in 2011.[675]

Being a partnership, the next question is how such income will be allocated among the partners. While the partnership had an operating agreement that purported to provide for how the income and losses would be allocated, the Tax Court found that the operating agreement, in fact, had never been followed—and thus, the allocations found in it did not have substantial economic effect:

> To have substantial economic effect, allocations must be consistent with the underlying economic arrangement of the partners. The allocations made by Echo's operating agreement (based on capital accounts) do not have substantial economic effect. In all other respects, the partnership and its partners shared items 30-30-30-10, instead of following the formula provided by the operating agreement. This course of conduct makes clear that Echo did not adhere to the allocations in the operating agreement and instead allocated losses on the basis of the partners' 30%, 30%, 30%, and 10% ownership interests. The partners also did not follow the operating agreement's provisions for contributing capital or maintaining capital accounts.[676]

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[674] *Michael Hohlet ux. et al. v. Commissioner,* TC Memo 2021-5, p. 13

[675] *Michael Hohlet ux. et al. v. Commissioner*, TC Memo 2021-5, p. 14

[676] *Michael Hohlet ux. et al. v. Commissioner*, TC Memo 2021-5, p. 15

The Tax Court then determined the proper allocation, based on the partners' interests in the partnership:

> Because the allocations provided by the operating agreement do not have substantial economic effect, the partners' distributive shares of income are determined according to their interests in the partnership. A partner's interest in the partnership depends on the facts and circumstances.23 In these cases, during all four years Echo operated, it allocated losses according to the stated 30%, 30%, 30%, and 10% ownership interests. Allocation of the income in 2012 should follow the allocation of losses for each other year of the partnership's existence. Mr. Hohl and Mr. Blake should each have included a 30% share of the income from the discharge of indebtedness in their income for 2012.[677]

This case is an excellent example of what tends to happen to taxpayers whose view of the true nature of a transaction changes from year to year and ends up aligning with what happens to be the most favorable outcome in each year. Courts are skeptical of claims like the one we had in this case where, after relying on the treatment of the transaction as a loan for years to allow the partners to deduct the losses, the taxpayers attempt to argue for a different treatment in the one year that a loan treatment proves disadvantageous. And, most often, the Court rejects this change of treatment, forcing the taxpayers to live with the consequences of the view they had taken for years when that view was advantageous.

SECTION: 1366
FORMAL DRAFT OF PROPOSED FORM 7203 TO REPORT S CORPORATION STOCK AND DEBT BASIS ON FORM 1040 RELEASED

Citation: Draft Form 7203, 10/21/21

The IRS has released the official draft of the proposed Form 7203, *S Corporation Shareholder Stock and Debt Basis Limitations*,[678] to be used to report S corporation stock basis, debt basis, and allowed/disallowed losses on Forms 1040. The form is virtually identical to the one we discussed in July of 2021 when the IRS published information about the form in the Federal Register.[679]

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[677] *Michael Hohlet ux. et al. v. Commissioner*, TC Memo 2021-5,

[678] Draft Form 7203, *S Corporation Shareholder Stock and Debt Basis Limitations*, Draft as of October 21, 2021, https://www.irs.gov/pub/irs-dft/f7203--dft.pdf (retrieved October 23, 2021)

[679] Edward K. Zollars, CPA, "IRS Proposes New Form 7203 for S Corporation Shareholders to Report Basis Computations with Form 1040," *Current Federal Tax Developments* website, July 21, 2021, https://www.currentfederaltaxdevelopments.com/blog/2021/7/19/irs-proposes-new-form-7203-for-s-corporation-shareholders-to-report-basis-computations-with-form-1040 (retrieved October 23, 2021)

When the Form Must Be Filed with Form 1040

The parts of the form are virtually identical to the worksheets previously provided by the IRS in the Schedule K-1 instructions. Although the draft instructions were not released with the draft forms, the draft instructions for Schedule E, which have been issued, provide that the form will need to be attached in the following circumstances:

> If you are claiming a deduction for your share of an aggregate loss (or you receive a distribution, dispose of stock, or receive a loan repayment from an S corporation), check the box on the appropriate line in Part II, column (e), and attach Form 7203 to your return.[680]

Shareholder's Basis in Stock

Part I details the computation of the stock basis of the shareholder.

Name of S corporation | Employer identification number

Stock block (see instructions) ▶

Part I Shareholder Stock Basis

1	Stock basis at the beginning of the corporation's tax year			1	
2	Basis from any capital contributions made or additional stock acquired during the tax year			2	
3a	Ordinary business income (enter losses in Part III)	3a			
b	Net rental real estate income (enter losses in Part III)	3b			
c	Other net rental income (enter losses in Part III)	3c			
d	Interest income	3d			
e	Ordinary dividends	3e			
f	Royalties	3f			
g	Net capital gains (enter losses in Part III)	3g			
h	Net section 1231 gain (enter losses in Part III)	3h			
i	Other income (enter losses in Part III)	3i			
j	Excess depletion adjustment	3j			
k	Tax-exempt income	3k			
l	Recapture of business credits	3l			
m	Other items that increase stock basis	3m			
4	Add lines 3a through 3m			4	
5	Stock basis before distributions. Add lines 1, 2, and 4			5	
6	Distributions (excluding dividend distributions)			6	
	Note: If line 6 is larger than line 5, subtract line 5 from line 6 and report the result as a capital gain on Form 8949 and Schedule D. See instructions.				
7	Stock basis after distributions. Subtract line 6 from line 5. If the result is zero or less, enter -0-, skip lines 8 through 14, and enter -0- on line 15			7	
8a	Nondeductible expenses	8a			
b	Depletion for oil and gas	8b			
c	Business credits (sections 50(c)(1) and (5))	8c			
9	Add lines 8a through 8c			9	
10	Stock basis before loss and deduction items. Subtract line 9 from line 7. If the result is zero or less, enter -0-, skip lines 11 through 14, and enter -0- on line 15			10	
11	Allowable loss and deduction items. Enter the amount from line 47, column (c)			11	
12	Debt basis restoration (see net increase in instructions for line 23)			12	
13	Other items that decrease stock basis			13	
14	Add lines 11, 12, and 13			14	
15	**Stock basis at the end of the corporation's tax year.** Subtract line 14 from line 10. If the result is zero or less, enter -0-			15	

[680] Draft of 2021 Instructions for Schedule E, Draft as of September 28, 2021, p. 10, https://www.irs.gov/pub/irs-dft/i1040se--dft.pdf (retrieved October 23, 2021)

Basis in Debt Owed to the Shareholder by the Corporation

Part II handles the calculation of debt basis, with Part A providing information on the amount of each debt owed to the shareholder and whether the debt is a formal note or an open account debt.

Part II **Shareholder Debt Basis**

Section A—Amount of Debt (If more than three debts, see instructions.)

Description	Debt 1 ☐ Formal note ☐ Open account debt	Debt 2 ☐ Formal note ☐ Open account debt	Debt 3 ☐ Formal note ☐ Open account debt	Total
16 Loan balance at the beginning of the corporation's tax year				
17 Additional loans (see instructions)				
18 Loan balance before repayment. Combine lines 16 and 17				
19 Principal portion of debt repayment (this line doesn't include interest)	( )	( )	( )	( )
20 Loan balance at the end of the corporation's tax year. Combine lines 18 and 19				

Part B computes the actual debt basis as well as any gain that would be reportable due to repayments of the various debts.

Part II **Shareholder Debt Basis** *(continued)*

Section B—Adjustments to Debt Basis

Description	Debt 1	Debt 2	Debt 3	Total
21 Debt basis at the beginning of the corporation's tax year				
22 Enter the amount, if any, from line 17				
23 Debt basis restoration (see instructions)				
24 Debt basis before repayment. Combine lines 21, 22, and 23				
25 Divide line 24 by line 18				
26 Nontaxable debt repayment. Multiply line 25 by line 19				
27 Debt basis before nondeductible expenses and losses. Subtract line 26 from line 24				
28 Nondeductible expenses and oil and gas depletion deductions in excess of stock basis				
29 Debt basis before losses and deductions. Subtract line 28 from line 27. If the result is zero or less, enter -0- .				
30 Allowable losses in excess of stock basis. Enter the amount from line 47, column (d)				
31 **Debt basis at the end of the corporation's tax year.** Subtract line 30 from line 29. If the result is zero or less, enter -0-				
Section C—Gain on Loan Repayment				
32 Repayment. Enter the amount from line 19				
33 Nontaxable repayments. Enter the amount from line 26				
34 **Reportable gain.** Subtract line 33 from line 32 . . .				

Allowable Losses and Carryover Amounts

Finally, Part III calculates the allowable loss and the amounts of any carryovers to the following year:

Part III **Shareholder Allowable Loss and Deduction Items**

Description	(a) Current year losses and deductions	(b) Carryover amounts (column (e)) from the previous year	(c) Allowable loss from stock basis	(d) Allowable loss from debt basis	(e) Carryover amounts
35 Ordinary business loss					
36 Net rental real estate loss					
37 Other net rental loss					
38 Net capital loss					
39 Net section 1231 loss					
40 Other loss					
41 Section 179 deductions					
42 Charitable contributions					
43 Investment interest expense					
44 Section 59(e)(2) expenditures					
45 Other deductions					
46 Foreign taxes paid or accrued					
47 **Total loss.** Combine lines 35 through 46 for each column. Enter the total loss in column (c) on line 11 and enter the total loss in column (d) on line 30					

Form **7203** (12-2021)

SECTION: 6031
PENALTY RELIEF GRANTED IN CERTAIN CASES RELATED TO FILING NEW SCHEDULES K-2 AND 3 ON 2021 RETURNS

Citation: Notice 2021-39, 6/30/21

In Notice 2021-39,[681] issued at the same time as draft versions of the 2021 instructions for new Forms K-2 and K-3 for partnerships and S corporations, the IRS provided limited relief from penalties related to issues properly preparing those forms on 2021 tax returns.

The Notice describes the new forms as follows:

> Form 1065, Schedules K-2, Partners' Distributive Share Items — International, and K-3, Partner's Share of Income, Deductions, Credits, etc. — International, are new for taxable years beginning in 2021. These schedules replace, supplement, and clarify the reporting of certain amounts formerly reported on Form 1065, Schedule K, Partners' Distributive Share Items, line 16, Foreign Transactions, and Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc., Part III, Partner's Share of Current Year Income,

[681] Notice 2021-39, June 30, 2021, https://www.irs.gov/pub/irs-drop/n-21-39.pdf (retrieved July 1, 2021)

Deductions, Credits, and Other Items, line 16, Foreign Transactions. Schedules K-2 and K-3 also replace, supplement, and clarify reporting of certain amounts formerly reported on Form 1065, Schedule K, line 20c, Other items and amounts, and Schedule K-1 (Form 1065), Part III, line 20, Other information. The new standardized format assists partnerships in providing partners with the information necessary to complete their returns with respect to the international tax aspects of the Code and allows the IRS to more efficiently verify tax compliance.

For the same reasons, for taxable years beginning in 2021, Form 1120-S includes new Schedules K-2, Shareholders' Pro Rata Share Items — International, and K-3, Shareholder's Share of Income, Deductions, Credits, etc. — International. These schedules replace, supplement, and clarify the reporting of certain amounts formerly reported on line 14, Foreign Transactions, of both Form 1120-S, Schedule K, Shareholders' Pro Rata Share Items, and Schedule K-1 (Form 1120-S), Shareholder's Share of Income, Deductions, Credits, etc. Part III, Shareholder's Share of Current Year Income, Deductions, Credits, etc. Schedules K-2 and K-3 also replace, supplement, and clarify the reporting of certain amounts formerly reported on Form 1120-S, Schedule K, line 17d, Other items and amounts, and Schedule K-1 (Form 1120-S), Part III, line 17, Other Information.

Finally, for the same reasons, for taxable years beginning in 2021, Form 8865 includes new Schedules K-2, Partners' Distributive Share Items — International, and K-3, Partner's Share of Income, Deductions, Credits, etc. — International. These schedules replace, supplement, and clarify the reporting of certain amounts formerly reported on line 16, Foreign Transactions, of both Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, Schedule K, Partners' Distributive Share Items, and Schedule K-1 (Form 8865), Partner's Share of Income, Deductions, Credits, etc., Part III, Partner's Share of Current Year Income, Deductions, Credits, and Other Items. Schedules K-2 and K-3 also replace, supplement, and clarify the reporting of certain amounts formerly reported on Form 8865, Schedule K, line 20c, Other items and amounts, and Schedule K-1 (Form 8865), Part III, line 20, Other information.[682]

Penalties Covered by the Relief

As the Notice describes, a failure to properly prepare and issue these forms for the applicable 2021 tax returns would subject the issuing entity to a number of penalties. The penalties discussed are:

682 Notice 2021-39, Section 2.02

- Failure to File or Show Information on Partnership Return (IRC §6698);
- Failure to File or Show Information on an S Corporation Return (IRC §6699);
- Failure to File Correct Information Returns (IRC §6721);
- Failure to Furnish Correct Payee Statements (IRC §6722); and
- Failure to furnish information required by IRC §6038 related to Form 8865 (IRC §§6038(b) and (c))[683]

In most cases, a failure would trigger more than one of these penalties absent a showing of reasonable cause for the failures. The Notice provides transition penalty relief to entities that will have to file the Schedules K-2 and K-3 on 2021 returns.

Relief and Conditions to Obtain Relief

The Notice describes the relief broadly as follows:

> This section provides transition relief for taxable years that begin in 2021 (processing year 2022) with respect to Schedules K-2 and K-3 to Forms 1065, 1120-S, and 8865. During this transition period, a partnership required to file Form 1065, an S corporation required to file Form 1120-S, or a U.S. partner required to file Form 8865 (a "Schedule K-2/K-3 filer") will not be subject to the relevant penalties described in section 2 for any incorrect or incomplete reporting on the Schedules K-2 and K-3 if the filer establishes to the satisfaction of the Commissioner that it made a good faith effort to comply with the Schedules K-2 and K-3 filing requirements (and the Schedule K-3 furnishing requirements) per the instructions. A Schedule K-2/K-3 filer that does not establish that it made a good faith effort to comply with the new requirements will not be eligible for penalty relief under this notice.[684]

The Notice outlines criteria the IRS will consider in determining if the filer made a good faith effort to comply for purposes of this relief:

> For purposes of determining whether a Schedule K-2/K-3 filer makes a good faith effort to complete Schedules K-2 and K-3, the IRS will take into account the extent to which a Schedule K-2/K-3 filer has made changes to its systems, processes, and procedures for collecting and processing information relevant to filing the Schedules K-2 and K-3 and the extent to which a Schedule K-2/K-3 filer has obtained information from partners, shareholders, or the CFP, or applied

[683] Notice 2021-39, Section 2.03
[684] Notice 2021-39, Section 3

> reasonable assumptions when information is not obtained. The IRS will also take into account the steps taken by the Schedule K-2/K-3 filer to modify the partnership or S corporation agreement or governing instrument to facilitate the sharing of information with partners and shareholders that is relevant to determining whether and how to file Schedules K-2 and K-3.[685]

The Notice explains that the IRS is aware that some of the items requested on these forms will require obtaining information about the interest holder:

> In several instances, certain information about partners, shareholders, or the CFP is relevant for determining the applicability of a part of Schedules K-2 and K-3. For example, if a partnership has a direct or indirect partner that is a nonresident alien individual or a foreign corporation, the partnership must complete Form 1065, Part X of Schedules K-2 and K-3. Information about the partners, shareholders, or the CFP is also relevant for determining how to report some amounts. For example, for taxable years beginning in 2021, the instructions for Form 1065, Part IX of Schedule K-2 and K-3 state that a partnership is expected to collaborate with its partners to identify the foreign-related parties of each partner.
>
> The Treasury Department and the IRS are aware that a Schedule K-2/K-3 filer may not currently have systems or procedures in place to obtain information about its partners, shareholders, or the CFP to determine whether it must file a part of Schedules K-2 and K-3 or how to complete a part that must be filed.[686]

The Notice goes on to explain what the filer must do to qualify for relief for issues arising related to these items:

> In general, in the taxable year 2021 instructions, unless the Schedule K-2/K-3 filer has knowledge to the contrary, it must file or complete certain parts assuming that the information would be relevant to the partner or shareholder. Under this notice, during the transition period, a Schedule K-2/K-3 filer will not be subject to the relevant penalties described in section 2 for any incorrect or incomplete reporting on Schedules K-2 or K-3 if it establishes to the satisfaction of the Commissioner that it made a good faith effort to determine whether it must file a part and how to complete a part that it files.
>
> With respect to information about partners, shareholders, or the CFP that is relevant to determine whether to file and how to complete a part, the IRS will assess the effort the Schedule K-2/K-3 filer made to

[685] Notice 2021-39, Section 3

[686] Notice 2021-39, Section 3

> obtain this information and the reasonableness of any assumptions, taking into account the relationship between the Schedule K-2/K-3 filer and its partners, shareholders or the CFP. For example, the appropriate level of diligence and/or the reasonableness of an assumption may differ with respect to a partner that manages or controls the partnership, or a partnership with a partner with a significant interest in the partnership, such as a partner with a 10-percent interest, as compared to partners holding small interests for which there may not be the same ease of access to information. Nevertheless, a Schedule K-2/K-3 filer may have made a good faith effort despite being unsuccessful in obtaining information from its partners, shareholders, or the CFP.[687]

The important thing to note about this relief is that it is very much *conditional* relief—if the filer makes no effort to compile and obtain relevant information, the filer would not meet the conditions to obtain this relief. For this reason, filers should begin studying the draft instructions and the forms, determining how the filer would be able to compile or obtain the necessary information, and begin documenting the steps being taken, as well as the problems that arise in attempting to fully comply with the requirements.

Comments Being Requested

The Notice ends by requesting comments on the draft instructions to the various Schedules that were released at the same time as the Notice. The nature of the comments requested is described as follows:

> The IRS solicits comments on the draft instructions to Schedules K-2 and K-3 for taxable years beginning in 2021 being released the same date as this Notice, particularly any instances where the instructions do not provide sufficient guidance on how to complete the returns or where additional clarity is needed. The IRS is specifically interested in suggestions for addressing structures and situations that make it difficult to determine certain information (e.g.,, tiered partnership structures or publicly-traded partnerships).
>
> As discussed in section 3, in general, the instructions for taxable years beginning in 2021 for certain parts of the Schedules K-2 and K-3 require the partnership and the S corporation to report information unless the partnership and S corporation know that the information is not relevant to partners, shareholders, or indirect partners. The IRS solicits comments concerning reasonable assumptions Schedule K-2/K-3 filers could make in determining whether and how to complete Schedules K-2 and K-3 for years after the transition period and

[687] Notice 2021-39, Section 3

> whether these assumptions may differ between various parts of the Schedules K-2 and K-3.[688]

The Notice describes the method for submitting comments as follows:

> Comments should be submitted in writing and should include a reference to Notice 2021-39. Comments may be submitted in one of two ways:
>
> (1) Electronically via the Federal eRulemaking Portal at www.regulations.gov (type IRS-2021-0006 in the search field on the regulations.gov homepage to find this notice and submit comments).
>
> (2) Alternatively, by mail to: Internal Revenue Service, Attn: CC:PA:LPD:PR (Notice 2021-39), Room 5203, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044.
>
> All commenters are strongly encouraged to submit public comments electronically. The IRS expects to have limited personnel available to process public comments submitted on paper through the mail. These comments, submitted through the mail, may not be processed with enough time before revisions to the instructions need to be prepared. Until further notice, any comments submitted on paper will be considered to the extent practicable. The Treasury Department and the IRS will publish for public availability any comment submitted electronically, and to the extent practicable on paper, to its public docket.[689]

SECTION: 6226
IN BBA AUDIT, ITEM INCLUDED IN IMPUTED ADJUSTMENT EVEN IF NO PARTNER WOULD HAVE PAID TAX ON THE ITEM HAD IT BEEN REPORTED ON THE ORIGINAL RETURN

Citation: Chief Counsel Email 202129012, 7/23/21

IRS emailed advice is always tricky to interpret, since we are seeing only one side of a conversation in these cases—only the IRS attorney's response is provided. And, unlike more formal advice from the Chief Counsel's office, these emails do not follow a formal structure where the facts under consideration are outlined in the attorney's response.

[688] Notice 2021-39, Section 4
[689] Notice 2021-39, Section 4

But Chief Counsel Email 202129012[690] contains one side of a discussion that outlines an issue that arises with partnership examinations under the BBA centralized partnership audit regime, discussing if it matters that the partnership can show that if an item of adjustment had been properly reported by the partners no additional income tax would have resulted. The partnership would want to have this amount excluded from the imputed adjustment (IU) under the regime, which is generally subjected to tax at the highest marginal tax rate when paid by the partnership.

If the item is includable in income generally under Chapter 1 of Subtitle A of the IRC (normal taxes for federal income taxes), the email concludes that it does not matter if, due to other factors, these particular partners would not have paid any tax in the year in question if the amount had been properly reported:

> All adjustments to partnership-related items (PRIs) go into the computation of the imputed underpayment (IU) regardless of whether they would result in additional income tax if properly reported by the partners. The issue of whether there is a chapter 1 impact doesn't go into consideration of whether an adjustment goes into the IU computation but rather goes into the analysis of whether the item is a PRI or not. We are treating like 14 as a PRI (* * *).[691]

A simple example of how this could happen would relate to cancellation of indebtedness.

EXAMPLE

Mary and Twila are equal partners in the MT Partnership, a partnership subject to the BBA 2015 audit regime. The IRS examines the partnership's income tax return and it is determined that the partnership failed to report $25,000 of cancellation of indebtedness income. Under IRC §61(a)(11) cancellation of indebtedness is counted as income under IRC §61(a)(11) and thus is part of the imputed adjustment (IU).

Both Mary and Twila were insolvent at the date the debt was cancelled and had no attributes to be reduced under IRC §108(b) at the end of that year. Under IRC §108(a)(1)(B) cancellation of indebtedness of income is excluded from income when the taxpayer is insolvent at the time the debt is cancelled. However, per IRC §108(d)(6), the partnership itself does not qualify to apply this relief—rather, each partner must demonstrate their personal insolvency to qualify for the exclusion.

In this case, had the $25,000 of cancellation of indebtedness income been properly reported by the partnership on its original return, neither Mary nor Twila would have paid any additional tax, since they each would have qualified under IRC §108(a)(1)(B) to exclude the amount from income. However, in computing the imputed adjustment (IU) that would be used to compute the payment the partnership would make for the exam, the entire $25,000

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[690] CCE 202129012, July 23, 2021, https://www.taxnotes.com/research/federal/irs-private-rulings/e-mail-chief-counsel-advice/no-excluding-partnership-related-items-from-imputed-underpayment/76x8b (retrieved July 25, 2021)

[691] CCE 202129012, July 23, 2021

would be treated as subject to tax at the highest marginal individual rates for the year in question.

In this scenario, to avoid the imposition of a tax, the partnership would either need to elect to use the option under IRC §6226 to push out the adjustment to the partners (who then would compute a net zero addition to tax for the item) or have the partners voluntarily amend the prior year returns under the provisions of IRC §6225(c)(2) to avoid tax being paid by any party on these items.

Note, though, that in the case of an administrative adjustment request (AAR) under §6227, the amended return option to remove the partners' share of the IU is not available.[692] Partnerships subject to the BBA regime cannot simply amend the original partnership return, but rather must make use of the AAR procedures under §6227 to voluntarily fix issues found in prior years. In that situation, only a push-out election under IRC §6226 would avoid paying tax on this item of income under the position taken in this emailed advice.

Of course, if a partnership is eligible to opt-out of the application of the BBA via the election under IRC §6221(b) and its related regulations, it could avoid this problem by opting out of the BBA regime by checking the appropriate box on Schedule B of Form 1065 and filing a properly completed Schedule B-2 with the return. In that case, the traditional amended return procedures are available to the partnership, which would have the tax impact computed on amended returns of the individual partners.

SECTION: 6698
LIMITED PENALTY RELIEF OFFERED TO PARTNERSHIPS FOR REPORTING BEGINNING TAX BASIS PARTNERS' CAPITAL ON 2020 RETURNS

Citation: Notice 2021-13, 1/20/21

In Notice 2021-13[693] the IRS has provided for relief from penalties for certain incorrect reporting related to partners' tax basis capital accounts on Schedules K-1s.

The Notice describes the changes to K-1 capital account reporting that are effective for 2020 filings:

> Prior to the 2020 taxable year, partnerships could report their partners' capital accounts for the taxable year on Schedules K-1, Partner's Share

[692] IRC §6227(b)(1) which bars the use of IRC §6226(c)(2) provisions to reduce the IU

[693] Notice 2021-13, January 20, 2021, https://www.taxnotes.com/tax-notes-today-federal/information-reporting/partnerships-given-penalty-relief-some-incorrect-reporting/2021/01/21/2l6n5 (retrieved January 22, 2021)

of Income, Deductions, Credits, etc., using one of a variety of methods that are based on different principles (for example, tax basis, generally accepted accounting principles (GAAP), section 704(b) book, or any other method). Starting in the 2018 taxable year, however, the instructions for Form 1065 required partnerships that did not report tax basis capital accounts to their partners to report separately the beginning and ending tax basis capital account balance of any partner that would have a negative beginning or ending tax basis capital account balance.

Beginning in the 2020 taxable year, the 2020 Form 1065 Instructions require partnerships to calculate and report their partners' capital accounts using the transactional approach for the tax basis method, irrespective of whether the beginning or ending balance is negative for a partner. The instructions for Form 8865, Return of U.S. Persons with Respect to Certain Foreign Partnerships, refer to the Form 1065 Instructions for reporting partners' capital accounts. Under the transactional approach outlined in the 2020 Form 1065 Instructions, partnerships report partner contributions, each partner's share of partnership net income or loss, withdrawals and distributions, and other increases or decreases using tax basis principles, instead of methods based on other principles such as GAAP. The 2020 Form 1065 Instructions explain that if a partnership did not report its partners' capital accounts using the tax basis method in the 2019 taxable year and did not maintain its partners' capital accounts under the tax basis method in its books and records, the partnership may determine its partners' beginning capital accounts for the 2020 taxable year using any one of the following methods: the tax basis method, modified outside basis method, modified previously taxed capital method, or section 704(b) method (each as described in the 2020 Form 1065 Instructions).[694]

Penalties that Potentially Could Apply

The Notice also details the various penalties that can apply when these forms are properly completed by the partnership. The notice points out that a failure to properly complete the K-1 can trigger penalty for failure to timely file the partnership return (Form 1065) under IRC §6698:

> 'Section 6698 imposes a penalty for failing to file a return or report at the time prescribed therefor, or for filing a return or a report that fails to show the information required under section 6031. A return required under section 6031 includes Form 1065 and each Schedule K-1. A failure to file a partnership return that shows information

[694] Notice 2021-13, Section 2

> required under section 6031 would generally subject a partnership to the section 6698 penalty. A section 6698 penalty will not be imposed if it is shown that the failure is due to reasonable cause.[695]

A separate penalty applies to the failure to timely file the information return—and the Schedule K-1 is such an information return. Thus, a penalty under §6721 would also potentially apply if the form is not properly completed:

> Section 6721 imposes a penalty for any failure to file an information return on or before the required filing date, and for any failure to include all of the information required to be shown on the return or the inclusion of incorrect information. When regulations under section 6011 require a partnership to file a partnership return electronically, each Schedule K-1 required to be included with the return with respect to each partner is treated as a separate information return subject to the section 6721 penalty. See section 6724(e) of the Code. Failure to electronically file a correct Schedule K-1 when required would generally subject a partnership to a section 6721 penalty.[696]

A similar penalty will apply for failing to provide the partner with a properly completed statement in a timely fashion under IRC §6722:

> Section 6722 imposes a penalty for any failure to furnish a payee statement on or before the date prescribed therefor to the person to whom such statement is required to be furnished, and for any failure to include all of the information required to be shown on a payee statement or the inclusion of incorrect information. Section 6724(d)(2) provides a definition for "payee statement" that applies to section 6722. Under section 6724(d)(2)(A), a Schedule K-1 furnished to each partner is considered a payee statement. A failure to furnish a correct Schedule K-1 as required under section 6031 would generally subject a partnership to the section 6722 penalty.[697]

The Notice points out that the penalties for failing to file and provide the information returns can be escaped if the partnership shows reasonable cause for the failure and that it was not due to willful neglect:

> Section 6724 provides an exception to a penalty for any failure under sections 6721 and 6722 if it is shown that the failure is due to reasonable cause and not to willful neglect. Under § 301.6724-1 of the Procedure and Administration Regulations, a penalty is waived for reasonable cause only if the filer establishes that either there are significant mitigating factors with respect to the failure or the failure

[695] Notice 2021-13, Section 2
[696] Notice 2021-13, Section 2
[697] Notice 2021-13, Section 2

> arose from events beyond the filer's control. In addition, the filer must establish that the filer acted in a responsible manner both before and after the failure occurred.[698]

Finally, the Notice points out that the improper reporting could lead to an assessment of tax against the partnership under the BBA 2015 partnership audit rules, and that examination assessment could lead to an accuracy related penalty under §6662.

> Section 6662 imposes an accuracy-related penalty on portions of an underpayment attributable to one or more types of misconduct, such as negligence or substantial understatement of income tax. Under section 6221, the applicability of any penalties, additions to tax, or additional amounts that relate to an adjustment to a partnership-related item must be determined at the partnership level for partnerships subject to the centralized partnership audit regime enacted by the Bipartisan Budget Act of 2015, Pub. L. 114-74, 129 Stat. 584. Section 6233 makes partnerships subject to the centralized audit regime liable for the section 6662 penalties calculated on the imputed underpayment.[699]

As should be clear, at least in theory a failure to properly determine and report partners' tax basis capital accounts could expose a partnership to a rather significant amount of penalties.

Late Filing Penalty Relief (§§6698, 6721 and 6722)

Relief for the various late filing penalties is provided in Section 3 of the Notice.

The notice deals with relief when issues arise with the proper reporting and computation of the partners' beginning capital account balance on the tax basis, providing:

> A partnership will not be subject to a penalty under sections 6698, 6721, or 6722 due to the inclusion of incorrect information in reporting its partners' beginning capital account balances on the 2020 Schedules K-1 if the partnership can show that it took ordinary and prudent business care in following the 2020 Form 1065 Instructions to report its partners' beginning capital account balances using any one of the following methods, as outlined in the instructions: the tax basis method, modified outside basis method, modified previously taxed capital method, or section 704(b) method.[700]

[698] Notice 2021-13, Section 2
[699] Notice 2021-13, Section 2
[700] Notice 2021-13, Section 3

The Notice goes on to describe *ordinary and prudent business care* for these purposes:

> For purposes of this notice, "ordinary and prudent business care" means the standard of care that a reasonably prudent person would use under the circumstances in the course of its business in handling account information. In demonstrating ordinary and prudent business care, taxpayers are reminded that capital account balances are part of a partnership's books and records and must be maintained accordingly.[701]

The notice also provides relief from issues with ending capital account balances, but only to the extent the error arises due to errors in the beginning capital account:

> In addition, a partnership will not be subject to a penalty under sections 6698, 6721, or 6722 due to the inclusion of incorrect information in reporting its partners' ending capital account balances on Schedules K-1 in taxable year 2020 or its partners' beginning or ending capital account balances on Schedules K-1 in taxable years after 2020 to the extent the incorrect information is attributable solely to the incorrect information reported as the beginning capital account balance on the 2020 Schedule K-1 for which relief under this notice is available.[702]

Although this relief is limited in a way that may trouble advisers, the Notice reminds taxpayers that reasonable cause exceptions to these penalties are still available if this Notice doesn't deal with the issue:

> The penalty relief provided in this notice is in addition to the reasonable cause exception to penalties for failing to properly report the partners' beginning capital account balances, as described in section 2 of this notice.[703]

The late filing relief for errors in capital accounts concludes by providing that this relief will not apply to returns that are simply not filed, even with these errors, in a timely fashion:

> A partnership that fails to timely file a 2020 Form 1065, Form 8865, and Schedules K-1 is not eligible for the relief provided by this notice. A partnership that fails to include a partner's beginning capital account balance on the Schedule K-1 is also not eligible for relief.[704]

[701] Notice 2021-13, Section 3
[702] Notice 2021-13, Section 3
[703] Notice 2021-13, Section 3
[704] Notice 2021-13, Section 3

As well, this relief does not impact the requirement that a *partner* needs to have maintained accurate records for his/her basis in the partnership interest.

> This notice does not relieve a partner of its obligation to determine the adjusted basis of its interest in the partnership for purposes of determining its tax liability or that of any other person as prescribed in section 705 of the Code and § 1.705-1(a)(1) of the Income Tax Regulations.[705]

Relief for Accuracy Related Penalty Under §6662 in BBA Exams

If a partnership has an error that is eligible for relief under the "late filing" relief provisions of this ruling, the IRS Notice provides that the accuracy related penalty under IRC §6662 will not be asserted by the Service on that part of the understatement:

> The IRS will waive any accuracy-related penalty under section 6662 for any taxable year with respect to any portion of an imputed underpayment that is attributable to an adjustment to a partner's beginning capital account balance reported by the partnership for the 2020 taxable year to the extent the adjustment arises from the inclusion of incorrect information for which the partnership qualifies for relief under section 3 of this notice.[706]

However, the Notice provides that relief is strictly limited to those partnerships that meet the conditions for relief under the late filing section of the Notice:

> This notice does not prevent the IRS from imposing an accuracy-related penalty under section 6662 for any portion of an imputed underpayment related to capital account reporting by the partnership that is not described in the previous sentence.[707]

[705] Notice 2021-13, Section 3
[706] Notice 2021-13, Section 4
[707] Notice 2021-13, Section 4

Unit

9

Estate and Trust Developments

LEARNING OBJECTIVES

When you have completed this unit, you will be able to

› **Obtain** a general understanding of key estate and trust tax developments over the past year and apply them to specific taxpayer situations

SECTION: 2002
IRS ALLOWED TO CONSIDER POTENTIAL RECOVERY AGAINST EXECUTOR FOR DISTRIBUTIONS IN OFFER IN COMPROMISE CALCULATION OF REASONABLE COLLECTION POTENTIAL

Citation: Estate of Kwang Lee *v.* Commissioner, TC Memo 2021-92, 7/21/21

When dealing with a decedent's estate, an executor of the estate may face personal liability for taxes found to be due from the estate if the executor made a distribution that rendered the estate insolvent, assuming the executor had knowledge or notice of that liability or potential liability.[708]

Treasury Reg. §20.2002-1 provides (in part):

> ..[I]f the executor pays a debt due by the decedent's estate or distributes any portion of the estate before all the estate tax is paid, he

[708] 31 USC 3713, Treasury Reg. §20.2002-1

> is personally liable, to the extent of the payment or distribution, for so much of the estate tax as remains due and unpaid. [709]

The regulation continues to extend that potential liability to other parties, including heirs receiving the property.

> In addition, section 6324(a)(2) provides that if the estate tax is not paid when due, then the spouse, transferee, trustee (except the trustee of an employee's trust which meets the requirements of section 401(a)), surviving tenant, person in possession of the property by reason of the exercise, nonexercise, or release of a power of appointment, or beneficiary, who receives, or has on the date of the decedent's death, property included in the gross estate under section 2034 through 2042, is personally liable for the tax to the extent of the value, at the time of the decedent's death, of such property. See also the following related sections of the Internal Revenue Code: Section 2204, discharge of executor from personal liability; section 2205, reimbursement out of estate; sections 2206 and 2207, liability of life insurance beneficiaries and recipients of property over which decedent had power of appointment; sections 6321 through 6325, concerning liens for taxes; and section 6901(a)(1), concerning the liabilities of transferees and fiduciaries.[710]

In the *Estate of Kwang Lee v. Commissioner* [711]the application of this provision when the estate seeks an offer in compromise is considered. The key issue to be decided was whether the IRS is allowed to include the potential amounts the IRS could receive from the executor and heirs under the recovery provisions in the calculation of the reasonable collection potential.

At the time the estate sought an offer in compromise, the total assets of the estate amounted to $183,000 in a checking account. The estate offered that entire amount to settle the outstanding balance remaining on the $536,151 amount previously determined by the Tax Court[712] to be the amount due following an IRS examination of the estate tax return.

The estate argued that the provisions for recovery would not apply in this case. The Court described the test for when the executor would be personally liable as follows:

> An executor is personally liable for the unpaid claims of the United States to the extent the executor makes a distribution of assets from the

[709] Treasury Reg. §20-2002-1
[710] Treasury Reg. §20-2002-1
[711] *Estate of Kwang Lee v. Commissioner,* TC Memo 2021-92, July 20, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/reasonable-collection-potential-must-account-for-executor%2c-beneficiaries/76wsw (retrieved July 21, 2021)
[712] *Estate of Lee v. Commissioner*, T.C. Memo. 2009-84

> estate when either the estate was insolvent at the time of the distribution or the distribution rendered the estate insolvent and the executor had knowledge or notice of the Government's claim. 31 U.S.C. sec. 3713(b); *Leigh v. Commissioner*, 72 T.C. 1105, 1109 (1979); sec. 20.2002-1, Estate Tax Regs.[713]

The executor (Mr. Friese, a licensed attorney and municipal court judge) made distributions of $1,045,000 from July 2003 to February 2007, which left the estate with the $138,000 in the checking account. A key issue was that $640,000 was distributed on February 28, 2007.[714]

That $640,000 distribution was the key one since before that distribution the estate had more than enough available to pay the estate tax ultimately determined to be due, but after the distribution, the estate was well short of being able to pay that amount. But did the executor have actual knowledge or notice of this claim at that time?

To answer that question, we have to look at the IRS's examination and later Tax Court case. The Court described that as follows:

> The IRS selected the estate's return for examination and determined a $1,020,129 deficiency in estate tax, plus a $255,032 section 6651(a)(1) addition to tax for untimely filing and a $204,026 section 6662(a) accuracy-related penalty. The IRS mailed a notice of deficiency to Mr. Frese, as executor of the estate, on April 26, 2006. Mr. Frese timely filed a petition for redetermination of the deficiency with this Court. *Estate of Lee v. Commissioner*, T.C. docket No. 14511-06 (filed July 27, 2006). The Court entered a decision on March 24, 2010 (2010 decision), finding a $536,151 deficiency in estate tax due from the estate with no addition to tax or penalty. Id. Respondent assessed the unpaid tax against the estate on July 19, 2010.[715]

The key dates would be:

- IRS issues a notice of deficiency that totaled $1,479,187 in taxes, interest, and penalties on April 26, 2006, which the taxpayer disputed and took to the U.S. Tax Court;
- March 24, 2010 when the U.S. Tax Court entered its decision for $536,151 in the case; and
- July 19, 2010 when the IRS assessed the unpaid tax against the estate.[716]

[713] *Estate of Kwang Lee v. Commissioner,* TC Memo 2021-92
[714] *Estate of Kwang Lee v. Commissioner,* TC Memo 2021-92
[715] *Estate of Kwang Lee v. Commissioner,* TC Memo 2021-92
[716] *Estate of Kwang Lee v. Commissioner,* TC Memo 2021-92

Obviously, on July 19, 2010, the executor was aware of the liability due to the U.S. government—but was the executor on notice prior to that date? More particularly, was the executor on notice before February 28, 2007, when the distribution that would eventually render the estate unable to pay the liability was made.

The IRS argued that the executor had notice when the notice of deficiency was sent on April 26, 2006, even though that amount was significantly more than was finally determined to be due. And the Tax Court decision agrees with this view:

> Respondent's notice of deficiency, issued to Mr. Frese before he made the February 2007 distribution, was sufficient to create a claim under the FPS. See *Viles v. Commissioner*, 233 F.2d at 379-380; *Irving Trust Co. v. Commissioner*, 36 B.T.A. at 148; *Estate of Frost v. Commissioner*, 1993 WL 75053, at *15. Furthermore, the record establishes that Mr. Frese had actual knowledge of the unpaid claim at the time of the February 2007 distribution. Respondent mailed the notice of deficiency to Mr. Frese in April 2006, and Mr. Frese was a named party in the petition filed with this Court disputing that deficiency claim in July 2006. *Estate of Lee v. Commissioner*, T.C. docket No. 14511-06.[717]

The executor argues that he made the distribution in February of 2007 on the advice of the estate's tax adviser, who presumably informed him that the estate would prevail before the Tax Court. Based on that or a similar assurance, he argued he decided he could proceed with the $640,000 distribution. The executor cited the case of *Little v. Commissioner*, 113 TC 474 (1999) where the Tax Court had "found that an executor did not have the requisite knowledge for purposes of the FPS because the executor, who did not have a college degree, was unaware of any potential or pending Government claims against the estate and reasonably relied in good faith upon multiple erroneous reassurances from counsel that the estate had no Federal tax liabilities."[718]

But the Tax Court found that this case was clearly distinguishable from the facts in *Little*. First, the Court found the executor had not presented evidence to show reliance on advice from the tax adviser on making the distribution.

> The estate offered no evidence to show that Mr. Frese relied upon the advice of the estate's tax adviser as it pertained to his decision to make distributions from the estate, including the February 2007 distribution.[719]

In a footnote, the Court points out that while the estate had prevailed on the "reliance on advice of a tax professional" to escape penalties in the earlier Tax Court decision,

[717] *Estate of Kwang Lee v. Commissioner,* TC Memo 2021-92
[718] *Estate of Kwang Lee v. Commissioner,* TC Memo 2021-92
[719] *Estate of Kwang Lee v. Commissioner,* TC Memo 2021-92

that does not mean the executor is deemed to have reasonably relied on such advice in deciding to move forward with actual distributions:

> The estate points out that we found the estate not liable for an addition to tax for untimely filing in *Estate of Lee v. Commissioner*, T.C. Memo. 2009-84, because Mr. Frese reasonably relied upon the estate's attorney in filing the estate's tax return. That case neither concerned nor considered advice given by the estate's attorney (or any other adviser) as it related to Mr. Frese's distributions of estate assets.[720]

The Court also noted that the executor was a licensed attorney in possession of a notice of deficiency, not an unsophisticated executor without any knowledge of the estate's potential liabilities:

> …[U]nlike the unsophisticated executor in Little who had no actual or constructive knowledge of the estate's tax liabilities at the time of the distributions, Mr. Frese, a licensed attorney and judge, made the February 2007 distribution with direct knowledge that respondent had determined an estate tax deficiency against the estate (respondent mailed him the notice of deficiency in April 2006) and that an action concerning that deficiency claim was pending before this Court.[721]

Based on the facts in this case, the Court went on to state:

> Under these circumstances, Mr. Frese made the February 2007 distribution at his own peril, and any advice he may have received in this regard cannot absolve him from liability. See *King v. United States*, 379 U.S. 329, 339-340 (1964); *New v. Commissioner*, 48 T.C. at 676-677; *Irving Trust Co. v. Commissioner*, 36 B.T.A. at 148. Thus, Mr. Frese may be held personally liable under the FPS for the estate's unpaid estate tax that remains due following the February 2007 distribution.[722]

Thus, the Court found that it was proper for the IRS to consider the potential collections from the executor and other parties in evaluating reasonable collection potential for an offer in compromise purposes.

[720] *Estate of Kwang Lee v. Commissioner,* TC Memo 2021-92
[721] *Estate of Kwang Lee v. Commissioner,* TC Memo 2021-92
[722] *Estate of Kwang Lee v. Commissioner,* TC Memo 2021-92

SECTION: 2703
BUY-SELL AGREEMENT FAILS TO SET VALUE OF DECEDENT'S INTEREST IN BUSINESS FOR ESTATE TAX PURPOSES

Citation: Estate of Connelly v. United States, USDC ED MO, Case No. 4:19-c-01410, 9/21/21

In the *Estate of Connelly v. United States*,[723] the US District Court for the Eastern District of Missouri determined that a buy-sell agreement did not set the value of the decedent's interest in a closely held corporation he owned a majority interest in and the proceeds of the life insurance policy held by the company that was used to redeem his shares from his estate had to be included in the calculation of the value of the company for estate tax purposes.

The opinion provides the following broad outline of the facts of this case:

> Brothers Michael and Thomas Connelly were the only shareholders in Crown C Supply, Inc., a closely-held family business that sold roofing and siding materials. As is typical in family businesses, the brothers entered into a stock purchase agreement that required the company to buy back the shares of the first brother to die, and the company bought life insurance to ensure it had enough cash to make good on the agreement. When Michael died in October 2013, Crown C repurchased his shares for $3 million, and Michael's Estate paid estate taxes on his shares in Crown C. But the IRS assessed additional estate taxes of over $1 million. Thomas, as executor of Michael's Estate, paid the deficiency and filed this suit seeking a refund. At the core of the dispute lies the question of the proper valuation of Crown C on the date of Michael's death.
>
> Aside from the life-insurance proceeds, Crown C was worth roughly $3.3 million on the date of Michael's death. On that date, Crown C had an obligation to repurchase Michael's shares from his Estate. Also, on that date, Crown C received (or was about to receive) a cash infusion of $3.5 million from the life-insurance proceeds; without these proceeds, Crown C would have had to deplete its assets or borrow money (or both) to buy Michael's shares.[724]

[723] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/life-insurance-proceeds-included-in-company%e2%80%99s-estate-tax-valuation/78c7k (retrieved September 23, 2021)

[724] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

The buy-sell arrangement entered into was described as follows:

> The Connelly brothers and Crown C signed a Stock Purchase Agreement (the "Stock Agreement") in 2001 to maintain family ownership and control over the company and to satisfy their estate-planning objectives. Id. at ¶¶ 13-14. The Stock Agreement provided that upon one brother's death, the surviving brother had the right to buy the decedent's shares, but the Stock Agreement required Crown C itself to buy (i.e., redeem) the deceased brother's shares if the surviving brother chose not to buy them. Id. at ¶ 15. When the brothers signed the Stock Agreement, they always intended that Crown C, not the surviving brother, would redeem the deceased brother's shares. Id. at ¶ 16.
>
> To fund its redemption obligation, Crown C bought $3.5 million in life-insurance policies on both Connelly brothers. Id. at ¶¶ 17-22. Article VII of the Stock Agreement provided two mechanisms for determining the price at which Crown C would redeem the shares. Id. at ¶ 23. Article VII specified that the brothers "shall, by mutual agreement, determine the agreed value per share by executing a new Certificate of Agreed Value" at the end of every tax year. Id. at ¶ 24; Doc. 53-4, Art. VII., Sec. A-B. If the brothers failed to execute a "Certificate of Agreed Value[,]" the brothers would determine the "Appraised Value Per Share" by securing two or more appraisals.2 Doc. 53-4, Art. VII., Sec. A, C. The Connelly brothers never signed a single Certificate of Agreed Value under the Stock Agreement. Doc. 58 at ¶¶ 25-36.[725]

Thus, per the terms of the agreement, since no Certificate of Agreed Value had ever been signed, if Michael's brother (Thomas) did not exercise the option to buy the shares directly from Michael's estate (which he did not), there should have been formal appraisals that would have been used to determine the value of the stock for redemption purposes. But that did not happen—rather, Thomas and Michael's estate came to a separate agreement that governed the sale:

> Upon Michael's death on October 1, 2013, Crown C received about $3.5 million in life-insurance proceeds. Id. at ¶ 39. Thomas chose not to buy Michael's shares, so Crown C used a portion of the life-insurance proceeds to buy Michael's shares from Michael's Estate. Id. at ¶ 16, 39-40. Crown C and the Estate did not obtain appraisals for the value of Michael's shares under the Stock Agreement, instead entering a Sale and Purchase Agreement (the "Sale Agreement") for the price of $3 million. Id. at ¶¶ 37-38, 64. Through the Sale Agreement, (1) the Estate received $3 million in cash; (2) Michael P. Connelly, Jr.,

[725] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

> Michael's son, secured a three-year option to purchase Crown C from Thomas for $4,166,666; and (3) in the event Thomas sold Crown C within 10 years, Thomas and Michael Jr. agreed to split evenly any gains from the future sale. Id. at ¶¶ 64-66.[726]

Thomas, as executor of his brother's estate, treated the value of the shares for estate tax purposes as $3 million (the amount paid from the life insurance proceeds to redeem the estate's interest). The IRS disagreed with that value, finding that the value of the company taken as a whole had to include the $3 million of life insurance proceeds the estate had the right to immediately upon Michael's death. The IRS adjustment in value resulted in an assessment of over $1 million in taxes on Michael's estate. The estate paid the tax in question and then filed suit to obtain a refund of the taxes in U.S. District Court. The parties stipulated that the value of the shares would be $3.1 million if the life insurance proceeds were found by the court to not be considered in determining the value of the company.

Stock Agreement

The first question before the Court was whether the buy-sell agreement controlled the value of the stock for estate tax purposes. Although under IRC §2703(a) the fair market value of the interest in the company is generally determined without regard to such agreements, IRC §2703(b) allows such an agreement to control the value if three standards are met:

- The arrangement is a bona fide business arrangement,
- The arrangement is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth, and
- The agreement's terms are comparable to similar arrangements entered into by persons in an arms' length transaction.[727]

The opinion notes that this issue may not actually be relevant in this case:

> The Court begins by observing that the Estate's arguments all turn on the same premise. The Estate argues that the company sold Michael's shares at fair market value, Doc. 65 at p. 7, which in turn relies on the assumption that the Estate's valuation expert correctly valued Michael's shares. The Estate's valuation expert, Kevin P. Summers, excluded $3 million in life-insurance proceeds from the valuation, presuming that the Eleventh Circuit's decision in Estate of Blount controls. Doc. 55-1 at pp. 11-12. And, even though the parties to the Sale Agreement did not value Michael's shares using the valuation

[726] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021
[727] IRC §2703(b)

> mechanisms set forth in Article VII of the Stock Agreement, the Estate nonetheless argues that the very existence of the Stock Agreement — the parties' failure to adhere to it notwithstanding — provides sufficient basis for the Court to accept Thomas and the Estate's ad hoc valuation as the proper estate-tax value of Michael's shares. Doc. 46 at pp. 8-9.[728]

But the opinion does look at the agreement to see if it fits the statutory requirements in any event. It is important to remember that the agreement has to meet *all three* of the requirements to be controlling for the value, so a failure to meet just one of the three requirements is enough to remove the agreement from controlling the value of the interest being redeemed.

Bona Fide Business Arrangement

The IRS first argues the agreement was not a bona fide business arrangement, arguing the brothers did not follow this agreement in good faith, raising both the disregard of the pricing provisions of the agreement and the retention by Michael's son of interest in any future sale.

The Court did not find the IRS's argument on this point persuasive, noting:

> "The ultimate question of whether there was a bona fide business arrangement is a question of fact[.]" See *Holman v. Comm'r*, 601 F.3d 763, 769 (8th Cir. 2010) (citing *Estate of True*, 390 F.3d at 1218-19). Courts have recognized the validity of agreements to maintain family ownership and control over closely-held businesses. *St. Louis Cty. Bank*, 674 F.2d at 1210. To establish that the Stock Agreement was a bona fide business arrangement, the Estate needed only to show that the Connelly brothers entered the Stock Agreement for a bona fide business purpose. See id. ("We have no problem with the District Court's findings that the stock-purchase agreement . . . had a bona fide business purpose — the maintenance of family ownership and control of the business."); *Estate of Lauder v. Comm'r*, 1992 WL 386276, *21 (T.C. 1992) (buy-sell agreements had a bona fide business purpose because the "agreements, on their face, serve the legitimate business purpose of preserving family ownership and control of the various Lauder enterprises. We are persuaded that these concerns were a motivating factor in the Lauders' decision to enter into the agreements."); *Estate of Gloeckner v. Comm'r*, 152 F.3d 208, 214 (2d Cir. 1998) ("[W]e agree with the tax court that the Gloeckner agreement represents a bona fide business arrangement. This test is sufficiently satisfied when the purpose of a restrictive agreement is to

[728] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

> maintain current managerial control — whether by family or outsiders.").[729]

In fact, the IRS had agreed to a stipulation that the brothers entered into the agreement to assure continued family control over the business, a reason that the cases cited found to be a valid business purpose for such an agreement. The opinion continues:

> The parties here have stipulated that the Connelly brothers entered the Stock Agreement for the purpose of ensuring continued family ownership over Crown C. Doc. 47 at ¶¶ 1-3. The IRS does not provide any support for its contention that the Estate's actions taken after Michael's death alter the purpose of the Stock Agreement, making it no longer a bona fide business arrangement. Doc. 61 at p. 12. Based on the parties' stipulation, the Court deems the Stock Agreement a bona fide business arrangement for purposes of summary judgment.[730]

While the Court did not conclude that the IRS would be unable to show that the brother's actions served to make the arrangement no longer meet the bona fide business arrangement test, that would require consideration of additional information by the court—thus, summary judgment could not be granted.

But whatever hope the estate might have had based on this finding was extinguished in the following sentence as the Court noted:

> Even so, resolution of this issue is ultimately unnecessary because the Stock Agreement fails to meet the other requirements under 26 U.S.C. § 2703(b).[731]

Device to Transfer Property to Family Members at Less Than Full and Adequate Consideration

The bottom line here is whether the buy-sell arrangement was a method to transfer wealth to the decedent's sibling for less than full and adequate consideration—and here, the Court would agree with the IRS that this was the case.

As the reader should note, this provision makes it much tougher for a buy-sell to be respected when the shareholders are related, since the question here is whether it is a design to transfer property to a family member—so had Michael and Thomas been unrelated, this issue would not have arisen. The burden is on the estate to show that the agreement was not such a device—a burden the estate did not carry.

[729] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021
[730] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021
[731] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

As we'll discuss later, the Court found that the life insurance proceeds had to be included as part of the value of the company, disagreeing with the holding of the Eleventh Circuit in the *Estate of Blount,*[732] instead agreeing with the original Tax Court analysis.[733] As Missouri is not in the Eleventh Circuit, but rather in the Eighth, the opinion of the Eleventh Circuit does not bind this Court if the opinion is not found to be persuasive on the issue—and the District Court did not find it so.

But even ignoring that issue, the Court found the actions of not following the agreement, but arguing it set the value, made it into solely a device to transfer assets to the decedent's brother at less than fair value. The opinion notes:

> …[E]ven though Crown C fulfilled the purpose of the agreement by redeeming Michael's shares, Thomas and the Estate's process in selecting the redemption price indicates that the Stock Agreement was a testamentary device. See *Estate of Gloeckner*, 152 F.3d at 216 ("[C]ourts scrutinize the processes employed in reaching the share price contained within the redemption agreement to shed light on the nature of the relationship between the decedent and the person to whom the stock was conveyed.") (citing *Estate of Lauder*, 1992 WL 386276, *21-22 and *Cameron W. Bommer Revocable Trust* v. C.I.R., 1997 WL 473161, at *13 (T.C. 1997)). Thomas and the Estate excluded a significant asset (the life-insurance proceeds) from the valuation of Crown C, failed to obtain an outside appraisal or professional advice on setting the redemption price, Doc. 58 at ¶¶ 23-38; Doc. 51 at p. 4, and as discussed further below, disregarded the appraisal requirement in Article VII of the Stock Agreement, see Section III.A.2.a-b, infra. See also *Estate of Lauder*, 1992 WL 386276, *21-22 (exclusion of major intangible assets, absence of a formal appraisal, and failure to obtain professional advice may mean the agreement is a testamentary device); *St. Louis County Bank*, 674 F.2d at 1211 (lack of regular enforcement of the buy-sell agreement's terms may mean the agreement is a testamentary device); *Estate of True*, 390 F.3d at 1222 ("[W]here the price term in a buy-sell agreement is reached in an arbitrary manner, is not based on an appraisal of the subject interest, or is done without professional guidance or consultation, courts draw an inference that the buy-sell agreement is a testamentary substitute.")[734]

The lack of a control premium for Michael's stock and a minority discount for the value of the stock held by Thomas was also found to indicate that this was a mere device to get the stock to Thomas while bypassing an estate tax on the value of that control premium:

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[732] *Estate of Blount v. Commissioner,* 428 F.3d 1388 (11th Circuit 2005)

[733] *Estate of Blount v. Commissioner*, TC Memo 2004-116, May 12, 2004

[734] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

> …[T]he Stock Agreement's lack of a minority discount for Thomas's shares and corresponding lack of a control premium for Michael's shares substantially overvalues Thomas's shares and undervalues Michael's shares. The Stock Agreement required that in determining the appraised value of the shareholders' shares in Crown C, "[t]he appraisers shall not take into consideration premiums or minority discounts[.]" Doc. 53-4, Art. VII., Sec. C. The Stock Agreement's lack of a control premium for Michael's majority interest indicates that the price was not full-and-adequate consideration. See 26 C.F.R. § 20.2031-2(f)(2) (fair market value for a corporation's stock is determined by "the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors" including "the degree of control of the business represented by the block of stock to be valued . . ."); *Bright's Estate v. U.S.*, 658 F.2d 999, 1006-7 (5th Cir. 1981) (a willing buyer would account for a controlling interest or a minority interest in a closely-held corporation); *Estate of True v. Comm'r*, 2001 WL 761280, at *100 (T.C. 2001) ("[Plaintiff's] 58.16-percent interest represented a majority of the shares entitled to vote; therefore, [Plaintiff] owned a controlling interest in Black Hills Trucking at his death. Accordingly, [the expert] should have added a control premium to compute entity value . . ."); see also *Zaiger's Estate v. Comm'r*, 64 T.C. 927, 945-46 (T.C. 1975) ("Petitioner's experts applied discounts to their valuations to reflect the minority interest involved and to compensate for the fact that voting control would not be in the hands of the purchaser. Such considerations were proper and discounts were appropriate.").[735]

Advisers are able to use minority discounts in many estate planning situations because that is found to reflect the economic reality—a buyer will pay a premium for a controlling interest in an enterprise and will demand a discount for a minority interest without such control. These are not concepts the estate or its advisers can simply ignore when not convenient—the IRS has just as much right to assert their actual economic relevance in the minds of a willing buyer.

Thus, the opinion concludes:

> While the Connelly brothers' good health when they executed the Stock Agreement weighs in favor of the Estate's argument, the parties' abject disregard of the Stock Agreement so as to undervalue the company and underpay estate taxes, as well as the Stock Agreement's lack of a control premium or minority discount, demonstrates that the Stock Agreement was a testamentary device to transfer wealth to

[735] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

> Michael's family members for less than full-and-adequate consideration. See Section III.A.2.a-b, infra.[736]

Note that the last two issues do not depend on the Court's rejection of the Eleventh Circuit view of how the life insurance proceeds should be treated for valuing the company. Failing to follow the buy-sell agreement's terms to negotiate a separate deal and having an agreement that fails to take into account valuation concepts such as control premiums would put a buy-sell agreement at risk of being disregarded for estate tax valuation purposes even if the life insurance proceeds are excluded from the valuation as a matter of law.

Comparable to Similar Arm's Length Agreements

The court also found that the estate failed to show this agreement was comparable to similar agreements negotiated at arm's length.

Much of the Court's conclusions rests on its view that the life insurance proceeds had to be included in the company's value, thus rendering the amount paid well below the true value. But the court also again found that the lack of payment of a control premium for Michael's majority interest also was a key factor in finding this agreement was not like one that would be negotiated between unrelated parties in arms' length negotiations.

Fixed and Determinable Offering Price

The opinion notes that, in addition to the statutory requirements just discussed, case law and the regulations require an agreement to provide a fixed and determinable price in order to be respected. In practice, the IRS argued that this agreement simply didn't provide such a readily determinable price:

> The IRS contends that the price of Michael's Crown C shares was not fixed and determinable under the Stock Agreement because Thomas and the Estate ignored the agreement's pricing mechanisms and came up with a valuation of their own. Doc. 52 at p. 7; Doc. 61 at p. 5. The Stock Agreement required shareholders Michael and Thomas to agree on and sign "Certificates of Agreed Value" every year to establish the price-per-share; but in the 12 years the agreement was in place before Michael's death, they never agreed on the value, or created or signed such certificates. Doc. 61 at p. 5; Doc. 53-4, Art. VII., Sec. A-B. Under the Stock Agreement, the failure of the shareholders to do so triggered the obligation to obtain the Appraised Value Per Share through a very specific process involving multiple professional appraisers. Doc. 53-4, Art. VII., Sec. C. But Thomas and the Estate never followed that specific process and never determined the Appraised Value Per Share; instead, they chose to come up with their

[736] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

> own ad hoc valuation of $3 million. Doc. 58 at ¶¶ 23-38; Doc. 51 at p. 4.[737]

The opinion agreed with the IRS that these issues meant that the agreement did not provide for a fixed and determinable share price arising from the buy-sell agreement.

The estate attempts to rescue this issue by arguing that the mere existence of such an agreement, even if ignored, satisfied this requirement. That is, had the brothers set a value each year or had appraisers been used to arrive at the value (rather than just an agreement between the estate and the minority shareholder/executor), the agreement would have met this requirement. But the Court noted that, regardless, the value the estate placed on the shares was *not* obtained from this agreement:

> But the Estate does not ask the Court to apply one of the price-setting mechanisms set out in the Stock Agreement; it wants the $3 million price to control estate-tax valuation, even though that price has no mooring in the Stock Agreement. Id. Further, the Estate's citation to *Estate of Gloeckner* is unpersuasive, as in *Estate of Gloeckner*, the Commissioner conceded that the buy-sell agreement at issue had a "fixed and determinable" offering price. 152 F.3d at 213 ("The Commissioner does not dispute that the restrictive agreement affecting Gloeckner's shares meets the first three requirements. That is, it concedes the stock price at issue was fixed within the redemption agreement . . .").[738]

The opinion concludes that the agreement's mechanism was ignored because the parties believed it would result in a far higher value than served the parties' interests:

> The Estate argues that the $3 million price "resulted from extensive analysis of Crown C's books and the proper valuation of assets and liabilities of the company. Thomas Connelly, as an experienced businessman extremely acquainted with Crown C's finances, was able to ensure an accurate appraisal of the shares." Doc. 51 at p. 4. Leaving aside Thomas's obvious self-interest in arriving at a below-market valuation, this argument reveals the frailty of the Estate's position: the Estate didn't believe that the very specific valuation mechanism in the Stock Agreement produced an accurate value that bound the Estate, but the Court should treat it as if it did. The Court finds this position as untenable as it is unpersuasive.[739]

[737] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021
[738] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021
[739] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

Binding During Life and After Death

As well, the case law and regulations require that such an agreement, to set the value of the interest, must be binding both during life and after death.

The court did not agree with the IRS view that the agreement was not binding during life because the parties had failed to set a value annually:

> As discussed in section III.A.2.a, above, the Stock Agreement required shareholders Michael and Thomas to agree on and sign "Certificates of Agreed Value" every year to establish the price-per-share, but they never agreed on the value, or created or signed such certificates. Doc. 61 at p. 5; Doc. 53-4, Art. VII., Sec. A-B. During life, the parties did not treat that aspect of the Stock Agreement as binding, but the Stock Agreement (for reasons unknown) anticipated that they might not comply with Certificates-of-Agreed-Value provision; accordingly, and insofar as the binding-during-life-and-death analysis goes, the Court does not find the parties' failure in this regard entirely dispositive. See Doc. 53-4, Art. VII., Sec. C.[740]

The existence of a "fall back" provision should the parties fail to set a value did provide a mechanism for the agreement to continue to operate even in that condition. But what happened at Michael's death proved that the parties did not view the agreement as binding at death:

> The parties' own conduct demonstrates that the Stock Agreement was not binding after Michael's death. Thomas and the Estate failed to determine the price-per-share through the formula in the Stock Agreement. See St. Louis County Bank, 674 F.2d at 1210-11 (parties' post-execution conduct can determine whether the court applies the terms of a buy-sell agreement for estate-tax purposes); Estate of Lauder, 1992 WL 386276, *19 (allowing some minor deviations from the buy-sell agreement's terms, but finding that the family still considered the agreement's terms to be binding because the family executed formal waivers and modifications as the buy-sell agreement required). As already discussed in section III.A.2.a, Thomas and the Estate did not consider the Stock Agreement to be binding or enforceable on them; they ignored the price mechanism in Article VII and sold Michael's shares for $3 million without first obtaining any appraisals for Crown C.[741]

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[740] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

[741] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

Fair Market Value

Having now determined that the buy-sell agreement does not qualify to set the value of the decedent's interest, the court turns to whether the life insurance proceeds should be considered when determining the value of the company.

The estate argues that the $3 million in life insurance proceeds triggered by Michael's death should be ignored because it is offset dollar for dollar by an obligation that existed to redeem Michael's interest in the corporation. The Eleventh Circuit in *Blount* had arrived at exactly that view:

> The Tax Court in *Estate of Blount* included the life-insurance proceeds in the value of the company and the shareholders' shares, determining that the redemption obligation was not like an ordinary liability because the redemption involved the very same shares being valued. 2004 WL 1059517, at *26. The Eleventh Circuit reversed on this issue, holding that the fair market value of the closely-held corporation did not include life-insurance proceeds used to redeem the shares of the deceased shareholder under a stock purchase agreement. *Estate of Blount*, 428 F.3d at 1346. The Eleventh Circuit reasoned that the stock-purchase agreement created a contractual liability for the company, offsetting the life-insurance proceeds. Id. at 1345-46. The Eleventh Circuit concluded that the insurance proceeds were "not the kind of ordinary nonoperating asset that should be included in the value of [the company] under the treasury regulations" because they were "offset dollar-for-dollar by [the company's] obligation to satisfy its contract with the decedent's estate." Id. at 1346 (citing 26 C.F.R. § 20.2031-2(f)(2)).[742]

However, this court does not accept the Eleventh Circuit's view—and, as was noted earlier, since this case would not have its appeal heard by the Eleventh Circuit the District Court was free to disagree with that view since the Eighth Circuit had not spoken to this issue.

The key issue is whether the redemption obligation was a corporate liability that would serve to reduce the value of the corporation. The opinion agrees with the Tax Court's view in this area that since the insurance proceeds would go directly to the holder of the shares being valued, it should not be excluded in valuing those shares prior to that asset being transferred to the holder of those shares:

> Under the willing-buyer-willing-seller principle, a redemption obligation does not reduce the value of a company as a whole or the value of the shares being redeemed. A redemption obligation requires a company to buy its own shares from a shareholder, and just like any other contractual obligation, a redemption obligation expends

[742] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

company resources. But as the Tax Court observed in *Estate of Blount*, a redemption obligation is not a "value-depressing corporate liability when the very shares that are the subject of the redemption obligation are being valued." 2004 WL 1059517, at *25.

Consider what a hypothetical "willing buyer" would pay for a company subject to a redemption obligation. See 26 C.F.R. § 20.2031-1(b). The willing buyer would not factor the company's redemption obligation into the value of the company, because with the purchase of the entire company, the buyer would thereby acquire all of the shares that would be redeemed under the redemption obligation; in other words the buyer would pay all of the shareholders the fair market value for all of their shares. The company, under the buyer's new ownership, would then be obligated to redeem shares that the buyer now holds. Since the buyer would receive the payment from the stock redemption, the buyer would not consider the obligation to himself as a liability that lowers the value of the company to him. See *Estate of Blount*, 2004 WL 1059517, at *25 (T.C. 2004) ("To treat the corporation's obligation to redeem the very shares that are being valued as a liability that reduces the value of the corporate entity thus distorts the nature of the ownership interest represented by those shares.").

A willing buyer purchasing Crown C on the date of Michael's death would not demand a reduced purchase price because of the redemption obligation in the Stock Agreement, as Crown C's fair market value would remain the same regardless. The willing buyer would buy all 500 of Crown C's outstanding shares (from Michael's Estate and Thomas) for $6.86 million, acquiring Crown C's $3.86 million in estimated value plus the $3 million in life-insurance proceeds at issue. If Crown C had no redemption obligation, the willing buyer would then own 100% of a company worth $6.86 million.

But even with a redemption obligation, Crown C's fair market value remains the same. Once the buyer owned Crown C outright, the buyer could either: 1) cancel the redemption obligation to himself and own 100% of a company worth $6.86 million, or 2) let Crown C redeem Michael's former shares — the buyer (and not Michael's Estate) would receive roughly $5.3 million in cash and then own 100% of a company worth the remaining value of about $1.56 million, leaving the buyer with a total of $6.86 million in assets. Therefore, with or without the redemption obligation, the fair market value of Crown C on the date of Michael's death was $6.86 million.[743]

[743] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

Or, to put it more simply, the buyer of all interests in the company ends up with either:

- A company worth $6.86 million (assuming the proceeds are retained by the company) *or*
- $3 million in cash and a company now worth $3.86 million following the redemption of the portion of the shares acquired that represented the decedent's interest.

The opinion then argues that what is really happening is a transfer of the full value of the company prior to the insurance proceeds to Thomas at no cost to him—a transfer for less than full and adequate consideration:

> Demonstrating this point, exclusion of the insurance proceeds from the fair market value of Crown C and valuing Michael's shares at $3 million results in drastically different share prices for Michael's shares compared to Thomas's. If on the date of his death, Michael's 77.18% interest was worth only $3 million ($7,774/share), that would make Thomas's 22.82% interest worth $3.86 million ($33,863/share) because Thomas owned all other outstanding shares and the residual value of Crown C was $3.86 million. See Doc. 53-19 at ¶ 61. The residual value of Crown C is the value of the company apart from the $3 million of insurance proceeds at issue. The parties have agreed that this value was $3.8 million. Doc. 48 at ¶¶ 1-3; Doc. 58 at ¶¶ 43, 79-81. Because Thomas was the only other shareholder of Crown C, his ownership interest must therefore equal the residual value of Crown C: $3.8 million. This outcome violates customary valuation principles because Thomas's shares would be worth 336% more than Michael's at the exact same time. See Doc. 53-19 at ¶ 61. A willing seller of Michael's shares would not accept this bargain, as it creates a windfall for the buyer (Crown C of which Thomas would now have 100% control), while undervaluing Michael's shares in comparison.
>
> Only by including the insurance proceeds in the fair market value of Crown C do Michael's and Thomas's shares hold an equal value on the date of Michael's death. Michael's 77.18% interest in a $6.86 million company would be worth $5.3 million ($13,782/share) and Thomas's 22.82% interest would be worth $1.56 million ($13,782/share). This outcome tracks customary valuation principles, because the brothers' shares have the same value-per-share. A willing seller of Michael's shares would only accept this outcome, because it assigns the same value to Michael's shares as to Thomas's and neither party's economic position changes through the transaction.[744]

[744] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021

Ultimately the opinion concludes:

> For these reasons, the Court respectfully finds that the Eleventh Circuit's opinion in *Estate of Blount* is "demonstrably erroneous" and there are "cogent reasons for rejecting [it]." *Keasler v. United States*, 766 F.2d 1227, 1233 (8th Cir. 1985) ("[T]he tax decisions of other circuits should be followed unless they are demonstrably erroneous or there appear cogent reasons for rejecting them." (internal quotation marks and citation omitted)). Accordingly, the Court holds that the $3 million in life-insurance proceeds used to redeem Michael's shares must be included in the fair market value of Crown C and of Michael's shares.[745]

SECTION: 6103
USER FEE OF $67 PROPOSED BY IRS TO OBTAIN ESTATE TAX CLOSING LETTER

Citation: REG–114615–16, 12/31/20

The IRS has proposed regulations to begin charging a user fee of $67 for an estate tax closing letter.[746]

The IRS explains its justification for taking this action as follows:

> In view of the resource constraints and purpose of issuing estate tax closing letters as a convenience to authorized persons, the IRS has identified the provision of estate tax closing letters as an appropriate service for which to establish a user fee to recover the costs that the government incurs in providing such letters. Accordingly, the Treasury Department and the IRS propose establishing a user fee for estate tax closing letter requests (see parts E and F for explanation of the authority to establish the user fee). As currently determined, the user fee is $67, as detailed in part H. [747]

The new closing letter fee is provided for in Proposed Reg. §300.13. The proposed fee, as noted, is set at $67.[748]

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[745] *Estate of Connelly v. United States*, USDC ED MO, Case No. 4:19-c-01410, September 21, 2021
[746] REG–114615–16, December 31, 2020, https://www.govinfo.gov/content/pkg/FR-2020-12-31/pdf/2020-28931.pdf (retrieved January 1, 2021)
[747] REG–114615–16
[748] Proposed Reg. §300.13(b)

The person liable for the fee when the closing letter is requested is referenced at Proposed Reg. §300.13(c), which states:

> *(c) Person liable for the fee.* The person liable for the fee is the estate of the decedent or other person properly authorized under section 6103 of the Internal Revenue Code to receive and therefore to request the estate tax closing letter with respect to the estate.[749]

The user fee is proposed to take effect 30 days after the regulations are published as final in the *Federal Register*.[750]

SECTION: 6677
SECOND CIRCUIT REVERSES TRIAL COURT, FINDS OWNER/BENEFICIARY OF FOREIGN TRUST LIABLE FOR 35% PENALTY FOR FAILURE TO REPORT A DISTRIBUTION

Citation: Emily Wilson, as Executrix of the Estate of Joseph A. Wilson v. United States of America, Case 20-603, CA2, 7/28/21

In November of 2019, we wrote[751] about the case of *Wilson, et. al. v. United States*, Case No. 2:19-cv-05037, US District Court, Eastern District of New York where a taxpayer prevailed in a case where he was the sole owner and beneficiary of a foreign trust. The owner/beneficiary was found to be liable for only the smaller 5% penalty under §6677(b) as the owner of a foreign trust that fails to file a report under IRC §6048. He was able to escape the 35% penalty imposed on a beneficiary for failing to report the receipt of a distribution from that trust as required by the same section.

However, the Second Circuit Court of Appeals has now reversed the District Court after the IRS appealed the decision,[752] finding that the 35% penalty the IRS had originally imposed was due in this case, noting:

> We vacate the court's judgment and hold that when an individual is both the sole owner and beneficiary of a foreign trust and fails to

[749] Proposed Reg. §300.13(c)

[750] Proposed Reg. §300.13(d)

[751] Edward K. Zollars, CPA, "Taxpayer Who Was Both Beneficiary and Owner of Foreign Trust Only Liable for Owner Penalty for Failure to File Form 3520," *Current Federal Tax Developments* website, November 22, 2019, https://www.currentfederaltaxdevelopments.com/blog/2019/11/22/taxpayer-who-was-both-benfeciary-and-owner-of-foreign-trust-only-liable-for-owner-penalty-for-failure-to-file-form-3520 (retrieved July 28, 2021)

[752] *Emily Wilson, as Executrix of the Estate of Joseph A. Wilson v. United States of America*, Case 20-603, CA2, July 28, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/foreign-trust-owner-beneficiary-faces-higher-reporting-penalty/76y5y (retrieved July 28, 2021)

> timely report distributions she received from the trust, the government has the authority under the IRC to impose a 35% penalty.[753]

The appellate panel described IRC §6048's reporting provisions as follows:

> Section 6048 of the IRC imposes disclosure requirements related to foreign trusts. Subsection (c) instructs "any United States person [who] receives . . . during any taxable year . . . any distribution from a foreign trust" to "make a return with respect to such trust for such year" that includes, inter alia, "the aggregate amount of the distributions so received from such trust." 26 U.S.C. § 6048(c). In other words, § 6048(c) requires beneficiaries of a foreign trust—such as Wilson—to disclose distributions they received from the trust in an annual filing. Subsection (b) orders U.S. owners "of any portion of a foreign trust" to "ensure that . . . such trust makes a return for such [taxable] year which sets forth a full and complete accounting of all trust activities and operations for the year" and "other information as the Secretary [of the Treasury] may prescribe." Id. § 6048(b).[754]

In this case, the owner/beneficiary failed to timely file Form 3520 and Form 3520-A for 2007.

> As a result, he did not timely disclose the $9.2 million distribution he received or report other information about his trust. The IRS assessed a late penalty of $3,221,183, 35% of the $9.2 million distribution. This penalty derives from § 6677(a) of the IRC, which provides "if any notice or return required to be filed by [§] 6048" is not filed on time or is incomplete, "the person required to file such notice or return shall pay a penalty equal to . . . 35 percent of the gross reportable amount." 26 U.S.C. § 6677(a).[755]

The panel notes the trial court's original holding in this matter:

> Plaintiffs moved for partial summary judgment on their 5% penalty argument, which the district court granted, concluding that "[t]he IRS can . . . assess only the 5% penalty under . . . § 6677—not both or either the 5% and/or 35% penalty—for Wilson's untimely filing of his 2007 Form 3520." *Wilson v. United States*, No. 19-CV-5037 (BMC), 2019 WL 6118013, at *8 (E.D.N.Y. Nov. 18, 2019).[756]

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[753] *Emily Wilson, as Executrix of the Estate of Joseph A. Wilson v. United States of America*, Case 20-603, CA2, July 28, 2021

[754] *Emily Wilson, as Executrix of the Estate of Joseph A. Wilson v. United States of America*, Case 20-603, CA2, July 28, 2021

[755] *Emily Wilson, as Executrix of the Estate of Joseph A. Wilson v. United States of America*, Case 20-603, CA2, July 28, 2021

[756] *Emily Wilson, as Executrix of the Estate of Joseph A. Wilson v. United States of America*, Case 20-603, CA2, July 28, 2021

The panel found that the trial court had misread the plain meaning of IRC §§6048 and 6077:

> The plain language of the IRC's disclosure and penalty provisions, §§ 6048 and 6677, unambiguously demonstrates that when an owner of a foreign trust fails to timely disclose a distribution she received as a beneficiary of that trust, she violates § 6048(c) and thereby triggers the 35% penalty under § 6677(a). Section 6048(c) states in relevant part:
>
> If any United States person receives (directly or indirectly) during any taxable year of such person any distribution from a foreign trust, such person shall make a return with respect to such trust for such year which includes . . . (B) the aggregate amount of the distributions so received from such trust during such taxable year.
>
> 26 U.S.C. § 6048(c)(1). Normally understood, "any United States person," *id.*, includes everyone, U.S. owners and beneficiaries of foreign trusts alike. The statute makes no exception for a beneficiary who is also the owner of a foreign trust. Wilson was therefore required under § 6048(c) to timely report the distribution he received from his trust.[757]

The panel goes on to describe the penalty provisions:

> Under § 6677(a), "if any notice or return required to be filed by [§] 6048 . . . is not filed on . . . time . . . the person required to file such notice or return shall pay a penalty equal to . . . 35 percent of the gross reportable amount." Id. § 6677(a). "[I]n the case of a failure relating to [§] 6048(c)," the "gross reportable amount" is "the gross amount of the distributions." Id. § 6677(c). Because Wilson failed to timely report under § 6048(c), the IRS assessed—in accordance with § 6677(a) and (c)—a penalty of 35% of Wilson's $9.2 million distribution.
>
> Nothing in other parts of §§ 6048 and 6677 diminishes or eliminates the applicability of the 35% penalty to Wilson as a beneficiary of the trust. However, the district court relied on § 6677(b) to conclude that the 35% penalty cannot apply. See Wilson, 2019 WL 6118013, at *6. Section 6677(b) "substitut[es] '5 percent' for '35 percent' [of the gross reportable amount]" as the applicable penalty for the failure to timely file "a return required under [§] 6048(b)," which is the reporting requirement for owners of foreign trusts. 26 U.S.C. § 6677(b). According to the court, because Wilson violated § 6048(b) by failing to timely file as an owner, § 6677(b)'s "mandate[] that the 5% replace

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[757] *Emily Wilson, as Executrix of the Estate of Joseph A. Wilson v. United States of America*, Case 20-603, CA2, July 28, 2021

> the 35%" applies. Wilson, 2019 WL 6118013, at *6 (emphasis omitted). [758]

The panel then deals with the specific flaw it identifies with the original reasoning that found that only the 5% penalty applies:

> The problem with the district court's analysis is that § 6677(b) leaves untouched the 35% penalty that applies to *all other* reporting requirements under § 6048, including to a return disclosing distributions required by § 6048(c). The district court and Plaintiffs do not identify any text in the statute that elides the requirement to disclose distributions received as a beneficiary under § 6048(c) when the beneficiary is also the owner of a foreign trust. Nor is there any textual support for the court and Plaintiffs' view that when the owner and beneficiary are one, a failure to timely report the distribution received violates only § 6048(b) and not § 6048(c). Even if the information the owner must report under § 6048(b) covers the trust's distributions, nothing in the statute indicates that as a result, § 6048(b) displaces or merges with the separate requirement to report distributions under § 6048(c). See id. at *6–7. Because Wilson's failure to timely report the distribution he received violates § 6048(c) even if that same failure also violates his reporting requirements as an owner under § 6048(b), the 5% penalty under § 6677(b) does not supplant the 35% penalty.[759]

The panel also disagrees with the trial court finding that the provision in IRC §6677(a) that provides a penalty should not "exceed the gross reportable amount," and "a taxpayer should not be liable for any two penalties if their combined assessment would add up to more than the gross reportable amount for any one violation" as support its ruling. The district court found that the gross reportable amount for an owner's untimely filing is the gross value of assets held at the end of the tax year, which was $0 at the end of 2007. Thus the government was limited to 5% of zero in this case.

However, the panel criticized this reading, stating:

> The court's reasoning misses the fact that "gross reportable amount" has more than one meaning under § 6677(c). The definition of "gross reportable amount" varies depending on the subsection of § 6048 an individual violated. For example, "*in the case of a failure relating to [§] 6048(b)(1)*" (the owner's filing requirement), the gross reportable amount is "the gross value of the portion of the trust's assets at the close of the year." 26 U.S.C. § 6677(c)(2) (emphasis added). By

[758] *Emily Wilson, as Executrix of the Estate of Joseph A. Wilson v. United States of America*, Case 20-603, CA2, July 28, 2021

[759] *Emily Wilson, as Executrix of the Estate of Joseph A. Wilson v. United States of America*, Case 20-603, CA2, July 28, 2021

> contrast, "*in the case of a failure relating to [§] 6048(c)*" (the beneficiary's filing requirement), the gross reportable amount is "the gross amount of the distributions." Id. § 6677(c)(3) (emphasis added). As a result, the prohibition against applying a penalty that "exceed[s] the gross reportable amount," id. § 6677(a), refers not to a single, common amount but instead is based on the specific violation. A 35% penalty of the "gross amount of the distributions," here $3.2 million, does not exceed the "gross reportable amount" of the $9.2 million Wilson received as the beneficiary.[760]

The panel also found that the law did not limit the IRS to assessing only a single penalty:

> Equally unavailing is Plaintiffs' contention that the government may only assess one penalty because § 6677(a) states that a "person required to file . . . [a] return [under § 6048] shall pay a penalty equal to . . . 35 percent." See id. § 6677(a) (emphasis added); Appellees' Br. at 31. "[A] penalty" does not mean the government may impose only a single penalty even if the taxpayer violates multiple filing requirements under § 6048. This is made clear by the fact that the same sentence upon which Plaintiffs rely states, in full, that "the person . . . shall pay a penalty equal to . . . 35 percent of the gross reportable amount," 26 U.S.C. § 6677(a) (emphasis added), and as discussed above "gross reportable amount" has different meanings, permitting more than one penalty depending on the nature of the untimely filing. The structure and text of § 6677 reflect that if an individual fails to timely file "*any* . . . return required to be filed by [§] 6048," *id.* (emphasis added), she is subject to a 35% penalty based on each return she fails to file as required under § 6048. Construed in its statutory context, "a penalty" cannot carry the weight with which Plaintiffs burden it.[761]

The panel also dismisses the trial court's analysis that looked at Forms 3520 and 3520-A, along with their instructions, as support for a one penalty only reading of the statute. The panel summarized the trial court's position in this area as follows:

> According to the court, because a trust owner who received a distribution and reported it in the trust's Form 3520-A "is not required to otherwise report the distribution on Form 3520," "Form 3520 disregards the beneficiary status of the trust owner in favor of his

[760] *Emily Wilson, as Executrix of the Estate of Joseph A. Wilson v. United States of America*, Case 20-603, CA2, July 28, 2021

[761] *Emily Wilson, as Executrix of the Estate of Joseph A. Wilson v. United States of America*, Case 20-603, CA2, July 28, 2021

> owner status, at least for the limited purpose of tracking distributions to the owner." *Id.*[762]

But the panel notes two issues with this view. First, the panel points out that the law looks at the information that must be disclosed, penalizing each failure, not basing a penalty on how many forms are required to make these disclosures:

> First, even if Wilson needed to file "a single Form 3520," id. at *6, § 6048 is concerned with the actual disclosure requirements, not the form on which the required disclosures are made. Filing a Form 3520 without providing all of the required information, such as the distributions, still violates § 6048.[763]

As well, the law requires a beneficiary to report any distributions he/she received, regardless of which form he/she is filing:

> Second, the court overlooks the fact that regardless of whether the person files Form 3520, Form 3520-A, or both, she must disclose any distributions she received from a foreign trust even if she is the sole owner and sole beneficiary. The option to disclose the distributions that an owner received from the trust in Form 3520-A does not "favor" the owner's status. Indeed, as the government articulated, "[t]he instructions simply provide that, if the foreign trust at issue filed a Form 3520-A that properly reported all distributions as part of the trust's annual reporting (which did not occur here), the trust owner can simply direct the IRS to the [Form] 3520-A already filed (by checking the appropriate box on Part II of Form 3520 and attaching his ownership statement) and need not report that information again on Part III of the Form 3520." Appellant's Br. at 47–48.[764]

Finally, the panel rejects the argument that the forms and their instructions create ambiguity on the reporting obligation, finding the unambiguous law controls regardless of what the forms may or may not imply:

> Relatedly, Plaintiffs argue that Form 3520-A (the annual return for the trust), which includes separate subsections to report distributions to owners and beneficiaries, and the instructions for the form "evidence that the [IRS] did not view a distribution to the trust owner to be reported as a distribution to a trust beneficiary." Appellees' Br. at 22. Plaintiffs see this as "further evidence that the [IRS] did not view a

[762] *Emily Wilson, as Executrix of the Estate of Joseph A. Wilson v. United States of America*, Case 20-603, CA2, July 28, 2021
[763] *Emily Wilson, as Executrix of the Estate of Joseph A. Wilson v. United States of America*, Case 20-603, CA2, July 28, 2021
[764] *Emily Wilson, as Executrix of the Estate of Joseph A. Wilson v. United States of America*, Case 20-603, CA2, July 28, 2021

distribution made to a trust owner as falling within the reporting requirements [of §] 6048(c) for beneficiaries." Id. Form 3520-A and its instructions carry no such implications. The separate reporting for owners and beneficiaries does not erase the owner's concurrent beneficiary status for the purpose of § 6048(c). Moreover, even if we were to find that the forms generate some ambiguity, "[t]he only role [extratextual] materials can properly play is to help 'clear up . . . not create' ambiguity about a statute's original meaning." *McGirt v. Oklahoma*, 140 S. Ct. 2452, 2469 (2020) (citation omitted).[765]

[765] *Emily Wilson, as Executrix of the Estate of Joseph A. Wilson v. United States of America*, Case 20-603, CA2, July 28, 2021

Unit 10

Tax Practice Developments

LEARNING OBJECTIVES

When you have completed this unit, you will be able to

- **Understand** when it is permissible, and when it is not, to use electronic signatures on tax documents
- **Obtain** a general understanding of tax practice developments in the past year

SECTION: FBAR REPORTING

IGNORANCE WAS NOT BLISS: CPA FOUND LIABLE FOR OVER $663,000 OF FBAR PENALTIES FOR ACCOUNTS HE FAILED TO REPORT

Citation: United States v. Kronowitz, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, 6/3/21

A CPA with 60 years of experience in preparing tax returns found that the Court wasn't very sympathetic regarding his failure to file FBAR reports, even though income had been (kind of) reported in the case of *United States v. Kronowitz*.[766]

Taxpayer's Background as a CPA

The taxpayer in this case was a CPA who had a small practice that consisted mainly of individuals and small local businesses.[767] His practice was described as follows:

[766] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/longtime-cpa-is-liable-for-willful-fbar-penalties/76khr (retrieved June 4, 2021)
[767] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

> Kronowitz was a professional tax preparer and has been preparing tax returns since 1961 or 1962. For the majority of his career, he prepared between thirty (30) and forty (40) tax returns per year. He began to wind down his practice in 2008 because of his declining health. Nevertheless, as recently as 2020, he was preparing tax returns for others for money. Indeed, for tax years 2019 and 2020, he prepared approximately ten (10) to fifteen (15) federal income tax returns each year. In his tax preparation practice, he prepared 1040s (personal returns) and 1120s (corporate returns) for subchapter S corporations. He also prepared his own tax returns.[768]

The Court noted that Mr. Kronowitz had been required to regularly attend continuing professional education courses:

> In order to maintain his CPA certification, he was required to participate every two years in eighty (80) hours of continuing professional education ("CPE"). During the course of his career, he took CPE courses such as Tax Shelter Seminar, Foreign Taxation, Offshore Trusts, and Asset Protection/Est[ate] Pl[an]ning. He does not recall the FBAR being specifically mentioned in any CPE class.[769]

Offshore Accounts

Mr. Kronowitz's offshore adventures began when a client allowed the CPA to invest in a portion of certain projects in different countries:

> Eli Levy, a real estate developer, was a client of Kronowitz's beginning in the 1970s. Kronowitz did Levy's Florida business returns but did not handle his personal returns or anything in other countries. However, Levy did give Kronowitz the opportunity to buy one or two percent of a couple of projects in different countries as a reward for good service. Kronowitz knew he was investing in properties in different countries.[770]

Mr. Kronowitz did not ask a lot of questions about the investments he made with Mr. Levy:

> Kronowitz invested with Levy mostly in the 1970s. He would meet with Levy in person and give him a check for the investment. In return, Levy did not give him any statement or confirmation of the investment because the documents were in foreign languages. In addition, according to Kronowitz, Levy told him that if he thought Levy was trying to "screw" him, then he should not invest with Levy.

[768] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021
[769] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021
[770] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

> Nevertheless, Kronowitz invested with Levy because he had a good feeling about Levy. Kronowitz never signed anything for Levy (other than the checks he gave Levy). Kronowitz's only record of his investments with Levy was a yellow legal pad on which he kept notes based on the investments. Kronowitz does not have the yellow legal pad anymore.[771]

As well, in 1999, Mr. Kronowitz became involved with a number of foreign entities which he believes may have been established via information he had given to Mr. Levy:

> In 1999, Kronowitz's signature and former office address appeared on a document titled "Management and Administration Agreement," (the "Agreement"), ECF No. [48-8], regarding the management of an entity called Cramo Stiftung/Foundation ("Cramo"). The Agreement is between Kronowitz and an entity named Consista Treuunternehmen ("Consista"), a company in Liechtenstein, and empowers Consista to manage Cramo on behalf of Kronowitz. The Agreement is also signed by an individual named Beat Kranz, on behalf of Consista, and as director of Cramo. Kronowitz is designated as the beneficial owner of Cramo's assets, and if he is deceased, his wife is the secondary beneficiary. Kronowitz testified that he does not know what Cramo Stiftung or Cramo Foundation is, and he never met Beat Kranz. Kronowitz testified that he may have spoken to Kranz once or twice on a phone call. Kronowitz gave his personal information to Levy, including his wife and children's names and birth dates, and believes that Levy must have given that information to Consista. Although Kronowitz does not remember signing any documents for Levy or Consista, his signature appears on the Agreement. ECF No. [48-8] at 3.
>
> On October 10, 2005, Cramo opened an account at United Bank of Switzerland ("UBS"), for which Kronowitz was listed as the beneficial owner on the account opening paperwork. Kronowitz was the beneficiary of the account held at UBS by Cramo from 2005 to 2009.[772]

Asset Protection and Offshore Accounts and Trusts

In addition to these investments, Mr. Kronowitz looked to utilize offshore accounts and trust for asset protection. As the opinion noted, one of the things he did remember being discussed at CPE courses was asset protection and the advantages of having assets offshore:

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[771] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

[772] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

> He does recall attending a course given by a University of Miami lecturer during which the movement of assets offshore for protection of those assets was discussed.
>
> Based upon Kronowitz's attendance at the CPE course in which he remembers being advised that professionals should move assets offshore for protection and a rumor that a former client, Irwin Mogerman, was going to sue him for fraud related to his work for Mogerman's company Grand Prix Race-o-Rama, Kronowitz opened two bank accounts in the Cayman Islands in 2001 ("Cayman Accounts"). Kronowitz had signature authority and was the financial beneficiary of the Cayman Accounts. His purpose in opening the Cayman Accounts was to keep funds out of reach from potential creditors[773]

Dealing with the Gains from the Levy Investments

Mr. Kronowitz had significant gains from the Levy investments, so he also established a trust and reported gain on the trust tax returns:

> By 2008, Kronowitz's investments with Levy had generated significant gains. In order to protect and manage the gains, Kronowitz created the 1210 Trust ("Trust"). In 2008, someone associated with Levy contacted Kronowitz and told him to contact Consista to direct where Kronowitz wanted the proceeds from his investments with Levy sent. In response, Kronowitz contacted Consista and instructed them to send the proceeds to one of his Cayman Accounts. He called the Caymans bank to verify that the wire transfers from Consista were completed. The Trust's assets in its bank account were comprised solely of transfers from Kronowitz's Cayman Accounts. Nevertheless, the Trust did not own the Cayman Accounts. Kronowitz used the information on the yellow legal pad to report the gains from his investments with Levy on his Trust's tax returns.
>
> On March 27, 2009, the funds held by Cramo at UBS were transferred to an account at Basler Kantonalbank ("BKB"), which was opened for Kronowitz's benefit. Kronowitz was identified as the beneficial owner of the account. All correspondence from the BKB account was directed to Consista.
>
> On August 11, 2009, Kronowitz sent correspondence to an individual with the initials "R.Z." and directed R.Z. to transfer $300,000.00 "to my account. You have the information on file." ECF No. [41] at 14, ¶ 56; see also ECF No. [48-9].

[773] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

> Finally, on December 6, 2010, Kronowitz e-mailed Consista and instructed them to "liquidate my account and forward all moneys as you did before to my account in the [C]aymans." Id. ¶ 57. On December 29, 2010, Cramo wired $318,067.53 to the Cayman Accounts.[774]

Dealing With Those Pesky FBAR Questions on Tax Returns

Mr. Kronowitz did report various items of income from the offshore investments on various tax returns—but answered any questions regarding the existence of offshore accounts with a "No."

> Kronowitz prepared his own tax returns for tax years 2005, 2006, 2007, 2008, 2009, and 2010. Schedule B is an attachment to the individual federal income tax return (Form 1040) that is used for reporting interest and dividend income, as well as any financial interest in, or signature authority over, financial accounts located in foreign countries. See ECF No. [41] at 9, ¶ 17. Kronowitz was required to file a Schedule B in conjunction with his 2005 through 2010 individual income tax returns; however, Kronowitz did not disclose his financial interest in foreign accounts in a Schedule B or in an FBAR for his 2005 through 2010 individual tax returns. In fact, on the Schedule B form filed with his 2008 tax return, in response to the question asking "[a]t any time during 2008, did you have an interest in or signature or other authority over a financial account in a foreign country, such as a bank account, securities account or other financial account?" Kronowitz marked "no." Id. at 10, ¶ 21. Furthermore, there were no Schedule B forms attached to the 2005, 2006, 2009, or 2010 individual tax returns.
>
> …
>
> Kronowitz also prepared the tax returns for the Trust for tax years 2008, 2009, and 2010. He marked "no" in response to the question asking, "[a]t any time during [the] calendar year [ ], did the estate or trust have an interest in or a signature or other authority over a bank, securities, or other financial account in a foreign country?" On the 2008 Trust tax return, Kronowitz disclosed $370,700.00 in gains from investments from Brazil, Panama, and Israel. On the 2009 Trust tax return, Kronowitz disclosed $281,725.00 in gains from investments in the Cayman Islands and Brazil. On the 2010 Trust tax return, Kronowitz disclosed $296,218.00 in gains from investments in foreign countries. However, beyond writing the names of certain of the Levy investments on the 2008, 2009, and 2010 Trust tax returns,

[774] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

> Kronowitz did not otherwise disclose his interest in any foreign accounts or assets. See ECF No. [48-6].[775]

Obviously, there are some issues here with how the tax returns in question were prepared. But Mr. Kronowitz testified that he had not read the instructions for Schedule B—and that reading such instructions wasn't really a concern of his:

> Kronowitz testified that he has probably seen hundreds of Schedule Bs throughout his career but admitted that he probably did not read the instructions to Schedule B because he is an accountant and not an attorney. In addition, he stated that he was more concerned with taking care of his clients and providing for his family.[776]

Failure to File FBAR Returns

As was noted, Mr. Kronowitz failed to file FBAR returns, even for years where he presumably had read the question regarding offshore accounts (since he answered the questions no). The Court provided Mr. Kronowitz's explanation:

> Although required to do so, Kronowitz admits that he did not timely file FBARs for tax years 2005 through 2010. In preparing tax returns, Kronowitz was aware of the question asking about interests in foreign accounts, but he did not do any research, nor did he look up form number TDF90-22.1 (the FBAR) referenced in the returns. He testified that he had not heard of the FBAR and that he had no knowledge that he was a beneficiary of the UBS and BKB accounts until he hired an attorney to represent him before the IRS during an audit in 2011. Kronowitz believed that if he reported the income from a foreign source on the Trust tax returns, he had complied with his tax obligations. He never asked anybody about this assumption—he thinks he heard it at a seminar or read it somewhere. He did not see a difference in reporting the income on the Trust return or on his individual return as long as the amounts were reported and the taxes paid.[777]

The IRS examined Mr. Kronowitz, and, unfortunately for Mr. Kronowitz, the IRS agent *did* know about the FBAR requirements. In November 2017, the IRS assessed penalties for failing to file FBAR forms for 2005-2010 in the amount of $663,771.[778]

The IRS's position was that Mr. Kronowitz's failure to file the FBAR returns was willful, which triggered these rather massive penalties.

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[775] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

[776] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

[777] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

[778] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

Willful Failure to File the Return and Recklessness

Obviously, Mr. Kronowitz claims that his failure to file these forms was not willful—he was just ignorant of his filing responsibilities, so how could his failure be willful?

However, the Court notes that to be willful under these rules, the violation does not have to be a knowing violation if the taxpayer behaves recklessly in failing to attempt to become properly aware of the responsibility.

> The statutes and regulations at issue, in this case, do not define the term willful; however, the BSA identifies the applicable penalty as a "civil money penalty." 31 U.S.C. § 5321(a)(5)(A). "[W]here willfulness is a statutory condition of civil liability, we have generally taken it to cover not only knowing violations of a standard, but reckless ones as well." *Safeco Ins. Co. of Am. v. Burr*, 551 U.S. 47, 57 (2007). "While the term recklessness is not self-defining, the common law has generally understood it in the sphere of civil liability as conduct violating an objective standard: action entailing an unjustifiably high risk of harm that is either known or so obvious that it should be known." *Id*. at 68 (quoting *Farmer v. Brennan*, 511 U.S. 825, 836, 114 S. Ct. 1970, 128 L. Ed 2d 811 (1994)) (internal quotations omitted). In the FBAR context, the United States Court of Appeals for the Eleventh Circuit recently held that "willfulness in the § 5321 includes reckless disregard of a known or obvious risk." *United States v. Rum*, --- F.3d ----, 2021 WL 1589153, at *6 (11th Cir. Apr. 23, 2021).[779]

Citing *United States v. Horowitz*, 978 F.3d 80, 89 (4th Cir. 2020), the opinion finds in this case willfulness based on recklessness is established if the taxpayer:

- Clearly ought to have known that
- There was a grave risk that an accurate FBAR was not being filed *and*
- He was in a position to find out for certain very easily.[780]

The Court found a number of factors that supported the view that Mr. Kronowitz's actions were reckless with regard to his FBAR filings.

First, the fact that he had been involved in tax practice for 60 years meant that he was not someone unaware of the tax in general—dealing with tax issues had been his primary business for his life.

[779] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021
[780] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

The Court was also not impressed with his failure to even consult the instructions for the Schedules that he was preparing:

> He admitted to seeing hundreds of Schedule Bs and being familiar with the purpose of Schedule B and its requirements but testified that he probably did not read the instructions because he was more concerned with providing for his family and taking care of his clients. Indeed, he testified that "my purpose in life at the time was to get clients, bill them, and collect the money, not spending the whole year reading[.]"[781]

This author is somewhat amazed the taxpayer expected the Court to believe that someone made it through 60 years of tax practice believing that actually spending time understanding the law he was supposedly following in serving his clients was unnecessary, as well as not realizing such understanding might help in keeping his family safe from the consequences of a failure to properly apply the law (in this case, an amount that has now grown to $753,680.37 by the time the Government filed its complaint).

As well, even what he did read (the questions asking if he had such foreign accounts) he either failed entirely to understand or just intentionally decided to answer in error:

> Furthermore, Kronowitz affirmatively answered "no" to questions regarding interests in foreign accounts on both his individual tax returns and on the Trust tax returns he prepared.[782]

Not wanting to read to find out the proper treatment of items, he claims to have developed his reporting positions by "assuming" none of the details mattered:

> He simply and incorrectly assumed that reporting the gains from his Levy investments would be sufficient to satisfy tax reporting obligations. When asked why he chose to report the gains on the Trust return as opposed to reporting the gains on his personal return, he responded that
>
> …that's where the money went, that's where the money came out to pay the taxes. Okay. From the 1210 Trust. I didn't see any big difference one way or the other. As long as they were reported and the taxes were paid.[783]

Unfortunately for the taxpayer, it turns out this did make a big difference.

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[781] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021
[782] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021
[783] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

Actions Aren't Consistent with a Simple Mistake

The Court also makes clear it doesn't really accept this is just the simple, innocent mistakes of someone who might not have been the most skilled tax researcher among CPAs. Rather, his actions suggest he remained willfully ignorant of key details (which I suspect the Court also believes explains his failure to want to spend time reading up on tax law):

> Beginning with his investments with Levy, Kronowitz displayed a surprisingly *laissez-faire* attitude—he simply gave Levy his money and did not ask any questions, even when he was given no receipt or acknowledgment for the funds he invested. He also failed to ask any questions about how his funds would be held for him or how he might access them if needed. Therefore, the Court does not assign much weight to the fact that Kronowitz did not know that he was the beneficiary of two Swiss bank accounts containing the proceeds from his Levy investments. He did not know because he never asked how Levy would handle his investments or the proceeds they might potentially generate. Moreover, even when he learned that his investments had generated significant gains, he still asked no questions and simply directed the transfer of funds to his Cayman Accounts. Similarly, in reporting the gains on those investments, he simply assumed that putting them on the Trust tax return would be sufficient—he neither did any research, nor did he ask anyone with more expertise if his assumption was correct. In addition, despite preparing hundreds of tax returns and his familiarity with the forms, which contain instructions and questions pertaining specifically to interests in foreign accounts, he never inquired whether his foreign accounts might trigger any additional obligations on his part.[784]

The circuitous route funds took to get into the Trust accounts additionally caught the attention of the Court.

> Moreover, the manner in which Kronowitz handled the gains from his Levy investments does not support a finding that he was simply mistaken, as opposed to reckless under the circumstances. Once Kronowitz learned that his investments with Levy had generated significant gains, he gave instructions for the funds to be transferred first to the Caymans to the Trust's bank account in the United States. In addition, he admittedly opened the Cayman Accounts to keep assets out of reach of potential creditors, like Mogerman, based upon advice he heard during a CPE course; but without conducting any follow-up to determine the potential tax effects of maintaining offshore accounts. See ECF No. [41] at 11, ¶ 27 ("The purpose of opening these

[784] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

> [Cayman Accounts] was that if Kronowitz was to be sued for malpractice, such funds could not be reached by the potential creditor."). Kronowitz testified at trial that in connection with the advice he heard regarding moving assets offshore, "[t]hat's when I opened the account in the Caymans and put some money over there. I didn't have a lot, but I put some." And while Kronowitz insists that there was no intent to defraud the IRS, no fraudulent intent is required for a finding of willfulness in the FBAR context.[785]

Finally, the Court rejected the claim that his declining health had compromised his cognitive abilities:

> In support of the defense that his failure to file FBARs was not willful or reckless, Kronowitz introduced evidence at trial. That evidence consisted of the testimony of his daughter, Tracy Falkowitz, and his wife, Sybil Kronowitz, that he has experienced significant declines in his health and memory in recent years. However, the evidence does not establish that Kronowitz's declining health affected his behavior during the relevant period, such that it would support a finding that his violations were not reckless. Although the Court is sympathetic to Kronowitz's recent lapses in memory and additional health complications, there was no medical evidence presented at trial to establish that Kronowitz's cognitive abilities were compromised during the relevant tax years. Rather, the evidence demonstrates that his actions related to the handling of his accounts and the gains from his investments with Levy were purposeful and deliberate.[786]

Court's Summary—The CPA Should Have Known

The Court concludes the opinion as follows:

> Based upon Kronowitz's background and experiences as a CPA and tax preparer, and the totality of his actions in this case, the Court finds that he clearly ought to have known that there was a grave risk that he was failing to comply with the FBAR requirements with respect to his foreign accounts. Furthermore, he was in a position to find out for certain very easily, had he taken the time to either conduct independent research or consult with another person more knowledgeable on tax law as to whether any additional reporting requirements might apply to him.[787]

[785] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021
[786] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021
[787] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

SECTION: 6011
IRS MAKES PERMANENT PROGRAM ALLOWING E-SIGNATURES FOR A SPECIFIC LIST OF FORMS

Citation: "Details on using e-signatures for certain forms," FS-2021-12, September 1, 2021

After initially beginning a temporary acceptance of certain e-signatures during 2020 as a response to the COVID-19 pandemic, then extending that program twice, dropping the "temporary" designation in the most recent extension, the IRS now appears to have made the program permanent in IRS Fact Sheet 2021-12.[788]

The IRS justifies allowing e-signatures on certain forms as follows:

> To help reduce burden for the tax community, the IRS allows taxpayers to use electronic or digital signatures on certain paper forms they cannot file electronically. The agency is balancing the e-signature option with critical security and protection needed against identity theft and fraud. Understanding the importance of electronic signatures to the tax community, the IRS offers an overview about using them on certain forms.[789]

The Fact Sheet provides that it will accept a "wide range of electronic signatures." The notice goes on to list the following specific methods that are deemed acceptable:

- A typed name typed on a signature block
- A scanned or digitized image of a handwritten signature that's attached to an electronic record
- A handwritten signature input onto an electronic signature pad
- A handwritten signature, mark or command input on a display screen with a stylus device
- A signature created by third-party software.[790]

While the Fact Sheet does not bar the use of other forms of e-signatures, professionals likely will want to use one of the specifically approved methods, if possible, to eliminate the risk of the IRS claiming the specific method used is not appropriate.

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788 "Details on using e-signatures for certain forms," FS-2021-12, September 1, 2021, https://www.irs.gov/newsroom/details-on-using-e-signatures-for-certain-forms

789 "Details on using e-signatures for certain forms," FS-2021-12, September 1, 2021

790 "Details on using e-signatures for certain forms," FS-2021-12, September 1, 2021

The Fact Sheet notes that various methods can be used to capture the e-signature:

> The IRS doesn't specify what technology a taxpayer must use to capture an electronic signature. The IRS will accept images of signatures (scanned or photographed) including common file types supported by Microsoft 365 such as tiff, jpg, jpeg, pdf, Microsoft Office Suite, or Zip.[791]

One missing format on that list is the HEIC (High-Efficiency Image Format) image format used by default by iPhones and other Apple products running recent versions of the company's operating systems (such as iOS 11 and later versions), so most likely they should be converted to JPEG or PDF for permanent storage if a professional receives files in that format.

Apple switched to that format as it is more space-efficient, but support outside of Apple products is more limited, specifically causing issues for Windows users who don't resort to third-party software. The lack of native Windows support likely explains why the IRS does not list this format in its list of clearly acceptable formats.

The IRS added more forms to those for which e-signatures will be accepted as the program was extended. The list of forms for which the IRS will deem electronic signatures acceptable are, as of September 1, 2021:

- Form 11-C, Occupational Tax and Registration Return for Wagering;
- Form 637, Application for Registration (For Certain Excise Tax Activities);
- Form 706, U.S. Estate (and Generation-Skipping Transfer) Tax Return;
- Form 706-A, U.S. Additional Estate Tax Return;
- Form 706-GS(D), Generation-Skipping Transfer Tax Return for Distributions;
- Form 706-GS(D-1), Notification of Distribution from a Generation-Skipping Trust;
- Form 706-GS(T), Generation-Skipping Transfer Tax Return for Terminations;
- Form 706-QDT, U.S. Estate Tax Return for Qualified Domestic Trusts;
- Form 706 Schedule R-1, Generation Skipping Transfer Tax;
- Form 706-NA, U.S. Estate (and Generation-Skipping Transfer) Tax Return;
- Form 709, U.S. Gift (and Generation-Skipping Transfer) Tax Return;

[791] "Details on using e-signatures for certain forms," FS-2021-12, September 1, 2021

- Form 730, Monthly Tax Return for Wagers;
- Form 1066, U.S. Income Tax Return for Real Estate Mortgage Investment Conduit;
- Form 1120-C, U.S. Income Tax Return for Cooperative Associations;
- Form 1120-FSC, U.S. Income Tax Return of a Foreign Sales Corporation;
- Form 1120-H, U.S. Income Tax Return for Homeowners Associations;
- Form 1120-IC DISC, Interest Charge Domestic International Sales—Corporation Return;
- Form 1120-L, U.S. Life Insurance Company Income Tax Return;
- Form 1120-ND, Return for Nuclear Decommissioning Funds and Certain Related Persons;
- Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return;
- Form 1120-REIT, U.S. Income Tax Return for Real Estate Investment Trusts;
- Form 1120-RIC, U.S. Income Tax Return for Regulated Investment Companies;
- Form 1120-SF, U.S. Income Tax Return for Settlement Funds (Under Section 468B);
- Form 1127, Application for Extension of Time for Payment of Tax Due to Undue Hardship;
- Form 1128, Application to Adopt, Change or Retain a Tax Year;
- Form 2678, Employer/Payer Appointment of Agent;
- Form 3115, Application for Change in Accounting Method;
- Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts;
- Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner;
- Form 4421, Declaration—Executor's Commissions and Attorney's Fees;
- Form 4768, Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes;
- Form 8038, Information Return for Tax-Exempt Private Activity Bond Issues;

- Form 8038-G, Information Return for Tax-Exempt Governmental Bonds;
- Form 8038-GC; Information Return for Small Tax-Exempt Governmental Bond Issues, Leases, and Installment Sales;
- Form 8283, Noncash Charitable Contributions;
- Form 8453 series, Form 8878 series, and Form 8879 series regarding IRS e-file Signature Authorization Forms;
- Form 8802, Application for U.S. Residency Certification;
- Form 8832, Entity Classification Election;
- Form 8971, Information Regarding Beneficiaries Acquiring Property from a Decedent;
- Form 8973, Certified Professional Employer Organization/Customer Reporting Agreement; and
- Elections made per Internal Revenue Code Section 83(b).[792]

The IRS Fact Sheet indicates that these are forms that cannot be filed using IRS e-file.[793] Thus, it seems unlikely that the IRS will allow e-signatures to be used for forms that can be electronically filed with the IRS and that any form on this list that is later added to the IRS e-file may be removed from the list.

Advisers must take care to not use this option for any forms not on the list. As we reported in July, the use of an unapproved signature method can cause the filing to be rejected as lacking a signature.[794]

SECTION: 6011
IP-PIN PROGRAM AVAILABLE TO ALL TAXPAYERS

Citation: "All taxpayers now eligible for Identity Protection PINs," IRS Website, 1/12/21

The IRS has outlined the details of its voluntary Identity Protection Personal Identification Number (IP-PIN) program where taxpayers will receive an IP-PIN, as

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[792] "Details on using e-signatures for certain forms," FS-2021-12, September 1, 2021

[793] "Details on using e-signatures for certain forms," FS-2021-12, September 1, 2021

[794] See Ed Zollars, CPA, "Digital Signature on 2014 and 2015 Amended Returns Was Not a Valid Signature," *Current Federal Tax Developments* website, July 15, 2021, https://www.currentfederaltaxdevelopments.com/blog/2021/7/15/digital-signature-on-2014-and-2015-amended-returns-was-not-a-valid-signature

well as opening up the process nationwide.[795] In the news release announcing the program, the IRS provides:

> The Identity Protection PIN (IP PIN) is a six-digit code known only to the taxpayer and to the IRS. It helps prevent identity thieves from filing fraudulent tax returns using a taxpayers' personally identifiable information.
>
> "This is a way to, in essence, lock your tax account, and the IP PIN serves as the key to opening that account," said IRS Commissioner Chuck Rettig. "Electronic returns that do not contain the correct IP PIN will be rejected, and paper returns will go through additional scrutiny for fraud."[796]

The news release notes a number of key facts taxpayers need to know before deciding if this program is right for them:

- This is a voluntary program.
- You must pass a rigorous identity verification process.
- Spouses and dependents are eligible for an IP PIN if they can verify their identities.
- An IP PIN is valid for a calendar year.
- You must obtain a new IP PIN each filing season.
- The online IP PIN tool is offline between November and mid-January each year.
- Correct IP PINs must be entered on electronic and paper tax returns to avoid rejections and delays.
- Never share your IP PIN with anyone but your trusted tax provider. The IRS will never call, text, or email requesting your IP PIN. Beware of scams to steal your IP PIN.
- There currently is no opt-out option, but the IRS is working on one for 2022.[797]

The lack of ability to opt-out of the program once a taxpayer has obtained an IP PIN is something that needs to be fully understood by any taxpayer deciding on participating in this program. If, for whatever reason, the taxpayer no longer can provide an IP PIN

[795] "All taxpayers now eligible for Identity Protection PINs," IRS Website, January 12, 2021, https://www.irs.gov/newsroom/all-taxpayers-now-eligible-for-identity-protection-pins (retrieved January 13, 2021)
[796] "All taxpayers now eligible for Identity Protection PINs," IRS Website, January 12, 2021
[797] "All taxpayers now eligible for Identity Protection PINs," IRS Website, January 12, 2021

or obtain a replacement, the only option is to file the return in paper form and expect an extended period to pass before the IRS finally pays out any refund that may be due.

For taxpayers that do want to use the program, the IRS offers the following instructions:

> Taxpayers who want an IP PIN for 2021 should go to IRS.gov/IPPIN and use the Get an IP PIN tool. This online process will require taxpayers to verify their identities using the Secure Access authentication process if they do not already have an IRS account. See IRS.gov/SecureAccess for what information you need to be successful. There is no need to file a Form 14039, an Identity Theft Affidavit, to opt into the program.
>
> Once taxpayers have authenticated their identities, their 2021 IP PIN will immediately be revealed to them. Once in the program, this PIN must be used when prompted by electronic tax returns or entered by hand near the signature line on paper tax returns.[798]

The IRS site describing the Secure Access program notes that taxpayers will need the following information to successfully complete the process:

- Email address
- Social Security Number (SSN) or Individual Tax Identification Number (ITIN)
- Tax filing status and mailing address
- One financial account number linked to your name:
  - Credit card—last 8 digits (no American Express, debit, or corporate cards) or
  - Student loan—(Enter the student loan account number provided on your statement. The account number may contain both numbers and letters. Do not include any symbols.) Additionally, we can't verify student loans issued by Nelnet. or
  - Mortgage or home equity loan or
  - Home equity line of credit (HELOC) or
  - Auto loan

[798] "All taxpayers now eligible for Identity Protection PINs," IRS Website, January 12, 2021

- Mobile phone linked to your name (for faster registration) or ability to receive an activation code by mail.[799]

The IRS does provide options for taxpayers who are unable to obtain a number via the online system. The first is for those with an adjusted gross income of $72,000 or less:

> Taxpayers whose adjusted gross income is $72,000 or less may complete Form 15227, Application for an Identity Protection Personal Identification Number, and mail or fax to the IRS. An IRS customer service representative will contact the taxpayer and verify their identities by phone. Taxpayers should have their prior-year tax return at hand for the verification process.
>
> Taxpayers who verify their identities through this process will have an IP PIN mailed to them the following tax year. This is for security reasons. Once in the program, the IP PIN will be mailed to these taxpayers each year.[800]

Other taxpayers will be forced to verify their identity in person if they want to use this program:

> Taxpayers who cannot verify their identities online or by phone and who are ineligible for file Form 15227 can contact the IRS and make an appointment at a Taxpayer Assistance Center to verify their identities in person. Taxpayers should bring two forms of identification, including one government-issued picture identification.
>
> Taxpayers who verify their identities through the in-person process will have an IP PIN mailed to them within three weeks. Once in the program, the IP PIN will be mailed to these taxpayers each year.[801]

This new program will not impact the program already in place for taxpayers with confirmed identity theft issues:

> Taxpayers who are confirmed identity theft victims or who have filed an identity theft affidavit because of suspected stolen identity refund fraud will automatically receive an IP PIN via mail once their cases are resolved. Current tax-related identity theft victims who have been receiving IP PINs via mail will experience no change.[802]

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[799] "Secure Access: How to Register for Certain Online Self-Help Tools," IRS Website, November 25, 2020, https://www.irs.gov/individuals/secure-access-how-to-register-for-certain-online-self-help-tools (retrieved January 13, 2021)

[800] "All taxpayers now eligible for Identity Protection PINs," IRS Website, January 12, 2021

[801] "All taxpayers now eligible for Identity Protection PINs," IRS Website, January 12, 2021

[802] "All taxpayers now eligible for Identity Protection PINs," IRS Website, January 12, 2021

SECTION: 6061
DIGITAL SIGNATURE ON 2014 AND 2015 AMENDED RETURNS WAS NOT A VALID SIGNATURE

Citation: Mills *v.* United States, United States Court of Federal Claims, 7/14/21

During the COVID-19 pandemic, many people turned to digital signatures to avoid meeting face to face. And, as we've noted in prior posts, the IRS also authorized the use of electronic signatures for many purposes.[803] If you search Google for "digital signatures legally binding" you are likely to get links to articles from many digital signature providers with headlines stating that such signatures are legally binding.

But if you read behind the headlines you will find caveats and exceptions. In the case of *Mills v. United States*,[804] the taxpayer discovered that signatures on tax documents are subject to specific requirements and his use of a digital signature did not count, costing him the chance to pursue his claim for refund.

The taxpayer in question was a U.S. citizen living in Australia working for a defense contractor. His path to this case dealing with electronic signatures began when he had a tax consulting firm look at his tax returns.

> In 2018, the plaintiff hired a tax-consulting firm, Castro & Co., LLC, to review his tax returns and to prepare amended returns. (Id. ¶ 45.) Castro & Co. determined that the plaintiff was entitled both to an FEIE[805] and to a tax exclusion for employer-provided lodging. (Id. ¶ 46.) The plaintiff had not claimed either exclusion on his original 2015 and 2016 tax returns. (Id.) Based on this assessment, the plaintiff sought to amend his returns.[806]

Mr. Mills initially tried to file amended returns by having an associate of the tax consulting firm sign the amended returns on his behalf:

> On November 29, 2018, the plaintiff filed Form 1040X, U.S. Amended Income Tax Returns, for both tax years 2015 and 2016 ("first amended returns"), claiming a refund of $10,950.00 and

[803] See Edward Zollars, "IRS Extends and Expands Temporary Deviation Allowing Some Forms to Be Signed Electronically or Digitally," *Current Federal Tax Developments* website, April 23, 2021, https://www.currentfederaltaxdevelopments.com/blog/2021/4/23/irs-extends-and-expands-temporary-deviation-allowing-some-forms-to-be-signed-electronically-or-digitally (retrieved July 15, 2021)

[804] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/%27digital-marks%27-on-amended-returns-spell-end-of-refund-suit/76vwb (retrieved July 15, 2021)

[805] Foreign Earned Income Exclusion

[806] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

> $1,764.00, respectively. (Id. ¶ 47; see also ECF 24-2, Ex. 5; ECF 24-3, Ex. 7.) Because he was living in Australia when he filed his first amended returns, the plaintiff did not sign them. (Mills Decl. ¶ 5; see also ECF 24-2, Ex. 5 at A-083; ECF 24-3, Ex. 7 at A-179.) Instead, Tiffany Michelle Hunt, an associate of Castro & Co., signed her name on the 2015 and 2016 amended returns on each return's line designated for the taxpayer's sworn signature in the jurat. (See ECF 24-2, Ex. 5 at A-083; ECF 24-3, Ex. 7 at A-179.) The name "John Anthony Castro," of Castro & Co., was typed on the line designated for the preparer's signature. (See ECF 24-2, Ex. 5 at A-083; ECF 24-3, Ex. 7 at A-179.) The plaintiff did not include a power of attorney with these first amended returns. (See ECF 24-2, Ex. 5; ECF 24-3, Ex. 7.)
>
> Several months after filing the first amended returns, the plaintiff filed a Form 2848, Power of Attorney and Declaration of Representative, which he signed on January 31, 2019. (Mills Decl. ¶ 6; see also ECF 24-3, Ex. 9.) On his Form 2848, the plaintiff indicated his authorization for John Anthony Castro, Tiffany Michelle Hunt, and Kasondra Kay Humphreys to represent him before the IRS. (Mills Decl. ¶ 6; see also ECF 24-3, Ex. 9.) Although the plaintiff gave these three representatives authority to act on his behalf for income-tax matters, he did not check the box in Part 5a of Form 2848, providing them with the authority to "[s]ign a return." (ECF 24-3, Ex. 9 at A-276.) The plaintiff signed the power of attorney form with his handwritten signature. (See id. at A-277.)[807]

Eventually, the IRS noticed that the taxpayer had not himself signed the returns in question:

> In a letter dated August 20, 2019, the IRS advised the plaintiff that the first amended returns did "not appear to have your signatures" and that it did "not appear that you have authorized a representative to sign a return on your behalf." (ECF 24-3, Ex. 11 at A-280.) The IRS requested the plaintiff submit 1040X forms bearing original signatures. (Id.)

By this time, the taxpayer was now on assignment in Afghanistan, facing the request that he hand sign the forms:

> In response to the IRS's request, on August 27, 2019, the plaintiff again filed Form 1040X, U.S. Amended Income Tax Returns, for tax years 2015 and 2016 ("second amended returns"). (ECF 1, ¶ 47; see also ECF 24-3, Exs. 6 & 8.) At the time of filing, the plaintiff was deployed by his employer to Afghanistan without an easily accessible unclassified printer to print, sign by hand, and scan the documents.

[807] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

> (Mills Decl. ¶¶ 9-11.) Instead of signing the forms by hand, the plaintiff attests that he electronically "signed" each Form 1040X with his initials, "KJM." (Id. ¶ 11; see also ECF 24-3, Ex. 6 at A-176, Ex. 8 at A-275.) He attests that he intended the digital markings to be his signature and to bind him to the second amended returns. (Mills Decl. ¶ 11.)[808]

Mr. Mills filed suit in the Court of Federal Claims attempting to get the refunds he claimed were due to him on the amended returns. But the IRS argued that Mr. Mills had failed to take the steps necessary to bring this matter before the United States Court of Federal Claims:

IRC §7422(a) provides:

> No suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed with the Secretary, according to the provisions of the law in that regard, and the regulations of the Secretary established in pursuance thereof.[809]

The IRS pointed out that the regulations required written verification under penalty of perjury and that such a claim must be signed properly.[810] The IRS's position was that such a digital signature was not an authorized method of signing this return at the time it was filed in August of 2019.

The Court noted that the IRS has provided little guidance on what is necessary for a signature, not defining the words *sign* or *signature*.[811]

Congress did direct the IRS to develop measures to accept electronic signatures in 1998, adding IRC §6061(b)(1), which provides:

> (b) Electronic signatures. —
>
> (1) In general. — The Secretary shall develop procedures for the acceptance of signatures in digital or other electronic forms. Until such procedures are in place, the Secretary may —
>
> (A) waive the requirement of a signature for; or

[808] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021
[809] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021
[810] Treasury Reg. §301-6402-2
[811] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

> (B) provide for alternative methods of signing or subscribing,
>
> a particular type or class of return, declaration, statement, or other document required or permitted to be made or written under internal revenue laws and regulations.[812]

The Court noted that over those more than twenty years, the IRS had not, until recently, developed any procedures to accept electronic signatures on amended returns. The Court also notes that while the IRS instructions for the original Forms 1040 for the years in question provide for accepting electronic signatures with a personal identification number, the instructions for amended returns had no comments on accepting electronic signatures.[813]

The taxpayer argued that his electronic signature should count as a signing of the amended return:

> The plaintiff argues that he did sign the second amended returns under penalty of perjury, as required by Treasury Regulation § 301.6402-2(b). He relies on the definition of "signature" found at 1 U.S.C. § 1: 'signature' or 'subscription' includes a mark when the person making the same intended it as such." 1 U.S.C. § 1.9 When he filed his second amended returns, the plaintiff was working in Afghanistan. (Mills Decl. ¶ 9.) Without an easily accessible unclassified printer to print, sign by hand, and scan the documents, the plaintiff attests that he electronically signed the form with his initials, "KJM," and intended those digital markings to be his signature and to bind him to the second amended returns. (Id. ¶¶ 9-11; see also ECF 24-3, Ex. 6 at A-176, Ex. 8 at A-275.) Although the plaintiff argues that, as a matter of policy, he should be allowed to submit an electronic signature in his unique situation, he cannot point to any source of law authorizing him to do so.
>
> The plaintiff also relies on the definition of electronic signature in the Government Paperwork Elimination Act ("GPEA"), Pub. L. No. 105-277, §§ 1701-10, 112 Stat. 2681 (1998). The GPEA provides that "[t]he term 'electronic signature' means a method of signing an electronic message that — (A) identifies and authenticates a particular person as the source of the electronic message, and (B) indicates such person's approval of the information contained in the electronic message." GPEA § 1710. The plaintiff cites a 2016 IRS Chief Counsel Advisory that provided that digital signatures are legally sufficient under the GPEA and I.R.C. § 6061(b)(1), the provision directing the Secretary to develop procedures for accepting signatures in digital or

812 IRC §6061(b)(1)

813 *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

> other electronic forms. Electronic Signatures & Form 2678, IRS CCA 201650019 (Dec. 9, 2016).

But the Court did not accept either justification. First, it notes that the law, by itself, did not allow for the taxpayer's digital signature.

> The Court, however, finds that I.R.C. § 6061(b)(1) does not, on its own, authorize the plaintiff's digital markings as a signature. Until the Secretary establishes procedures for digital or electronic signing, the Secretary *may*, but is not required to, waive the signature requirement or provide alternative methods of signing. I.R.C. § 6061(b)(1). The plaintiff has not pointed to any waiver or alternative method authorizing him to sign his second amended returns with digital markings as a signature. Similarly, 1 U.S.C. § 1 does not determine the meaning of signature in I.R.C. § 6061. The definition of "signature" in 1 U.S.C. § 1 applies "unless the context indicates otherwise." 1 U.S.C. § 1. Context indicates otherwise here; in fact, I.R.C. § 6061(b)(1) expressly governs electronic signatures on tax returns. See *First Nationwide Bank v. United States*, 431 F.3d 1342, 1348 (Fed. Cir. 2005) ("As a principle of statutory interpretation, a specific provision prevails against broader or more general provisions, absent clear contrary intent."). Under I.R.C. § 6061(b)(1), the plaintiff cannot digitally mark a tax return as a signature without a waiver or prescribed alternative method of signing.[814]

The Court also rejected the taxpayer's attempt to rely on the GPEA and a Chief Counsel Advisory, noting:

> The plaintiff's reliance on the GPEA and the Chief Counsel Advisory is likewise misplaced. As the plaintiff admits, the GPEA does not apply to the IRS. See GPEA § 1709 (providing explicitly that the GPEA does not apply to the Department of the Treasury or the IRS). As for the Chief Counsel Advisory, it "may not be used or cited as precedent." IRS CCA 201650019; see I.R.C. § 6110(k)(3) ("Unless the Secretary otherwise establishes by regulations, a written determination may not be used or cited as precedent.").
>
> Not only may the Chief Counsel Advisory not be relied on as precedent, but it also did not consider the question of electronic signatures on tax returns. *See generally* IRS CCA 201650019. The Advisory examined "whether the Service may accept a Form 2678, *Employer/Payer Appointment of Agent*, that displays an electronic signature." Id. (italics in original). Its conclusion cuts against the plaintiff's argument. The Advisory concluded that the IRS should not accept electronic signatures without published guidance:

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814 *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

> It is our view that an electronic signature should only be accepted by the Service when there are published guidance or [Internal Revenue Manual ("IRM")] provisions that specifically authorize the use of an electronic signature for the specific form involved. Since there is no guidance or IRM provisions authorizing the use of an electronic signature on Forms 2678, we recommend that the Service not accept Forms 2678 signed electronically until the Service authorizes its use for Forms 2678 either in published guidance or in the IRM.
>
> Id.[815]

The opinion notes that the taxpayer has not provided an example of a provision providing for such authorization to use the digital signature in the amended return situation:

> The plaintiff here has not cited any provision, in the IRM or otherwise, that authorized the use of an electronic signature on Form 1040X amended returns at the time he filed his second amended returns. That the plaintiff is unable to do so is not surprising. Electronic signatures are required for documents that may be submitted in electronic format; forms that have traditionally been filed in paper format must always have a handwritten signature.[816]

Thus, the Court finds the taxpayer has not submitted a signature with his amended return, and therefore the return is not treated as filed:

> The IRS had not established procedures for accepting electronic signatures on hard-copy amended returns, had not waived the signature requirement, and had not prescribed an alternative method of signing at the time the plaintiff filed his amended returns. Accordingly, the plaintiff's digital markings on his second amended returns do not meet the requirement that his returns "be signed" and, as a refund claim, "be verified by a written declaration that it is made under the penalties of perjury." I.R.C. § 6061(a); Treas. Reg. § 301.6402-2(b).[817]

[815] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021
[816] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021
[817] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

SECTION: 6051
IRS OPENS UP WEBSITE TO ALLOW FOR ELECTRONIC SIGNING AND SUBMISSION OF POWERS OF ATTORNEY

Citation: "Use Tax Pro Account," IRS website, 7/18/21

The IRS has opened up a website by which Circular 230 practitioners (CPAs, EAs and attorneys) can submit a Power of Attorney request.[818] The page contains information on using the service as well as the link to access the system. The IRS has also published an addition to the Internal Revenue Manual at 21.2.1.63[819] that describes the program and noted it would become available on July 18, 2021. The program is described as follows:

> Tax Pro Account is an online system, available to the public on July 18, 2021, that allows individual tax professionals to securely request third party authorizations for an individual taxpayer as power of attorney (POA) or tax information authorization (TIA), in lieu of filing a paper Form 2848, *Power of Attorney and Declaration of Representative*, or Form 8821, *Tax Information Authorization*.[820]

However, the IRM notes that "[t]he Tax Pro Account application does not have the [specific capabilities] that the forms allow, as detailed below."[821] That is, only a very limited set of authorizations can be handled via this system. In fact, advisers will note that the system, at least at the beginning, is very limited in the situations in which it can be used, and it will require the adviser's client to access the system as well as this system has both the professional and the client electronically sign the form.

To use the system the tax professional must verify their identity and pass an authorization process using the IRS Secure Access eAuthentication.[822] The professional must already have a Centralized Authorization File (CAF) number, be in good standing and not have been suspended or disbarred from practice before the IRS.[823]

The system's hours are provided as follows:

> The system will be available Monday 6:00 a.m. to Saturday 9:00 p.m. Eastern Time, and Sunday 10:00 a.m. to midnight Eastern Time.[824]

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818 "Use Tax Pro Account," IRS website, https://www.irs.gov/tax-professionals/use-tax-pro-account (retrieved July 18, 2021)
819 IRM Procedural Update, "Tax Pro Account - New Online System Interface," July 6, 2021, https://www.irs.gov/pub/foia/ig/wi/wi-21-0721-0914.pdf (retrieved July 18, 2021)
820 IRM 21.2.1.63.1
821 IRM 21.2.1.63.1
822 IRM 21.2.1.63.2
823 IRM 21.2.1.63.4
824 IRM 21.2.1.63.3

There are restrictions on the years available under this program:

> Authorizations for POA and TIA may be requested from the tax year 2000 through the current year, plus three additional years. For 2021 authorizations may be requested for 2000-2024. If the tax professional requires authorization for the tax year 1999 and prior, they must submit their request to the CAF unit on a Form 2848 or Form 8821.[825]

Filing a Form 2848 or Form 8821 will replace any existing authorization of the same type for the same year(s) on the taxpayer's account.[826] The IRS gives the following example of this replacement:

EXAMPLE (IRM 21.2.1.63.7)

Enrolled agent Grayson Smith has authority on taxpayer Mary Johnson's account for tax years 2000–2018. A new request for authority is made for 2017–2024 by Michael Williams on Mary Johnson's account. Once the request is processed, Grayson Smith will only have authority for 2000–2016, as Michael William's request via Tax Pro Account will invalidate Grayson's authorization on 2017 and 2018. In order to preserve Grayson Smith's authority on 2017–2018, Mary Johnson will have to file a Form 2848 or Form 8821, check the box to maintain a prior authorization, and include a copy of Grayson Smith's authorization.

The professional will need to have the following information in order to complete an online authorization request:

- Their CAF number.
- The name and address, as currently on file with their CAF number per IRS records. Address must be located in one of the 50 US States or the District of Columbia.
- The taxpayer's Taxpayer Identification Number (TIN).
- The taxpayer's name and address, as currently on file per the IRS records. Address must be (in) the 50 US States and District of Columbia.
- The Tax Matters and Tax Years for which they are requesting authority.[827]

The following items are not supported for representation requests submitted under this system and will require filing a paper form instead:

- Specific Use Not Recorded on CAF (line 4 of Form 2848 and Form 8821)

[825] IRM 21.2.1.63.6
[826] IRM 21.2.1.63.7
[827] IRM 21.2.1.63.8

- Additional Acts Authorized (line 5a on Form 2848)
- Specific Acts Not Authorized (line 5b on Form 2848)
- Retention/Revocation of Prior Power(s) of Attorney (line 6 on Form 2848), Retention/Revocation of Prior Tax Information Authorizations (line 5 on Form 8821)[828]

In Step 1, the IRS will have the tax professional enter their information, which the agency will verify. If the information does not match IRS records, the professional will need to correct the information to proceed.[829]

In Step 2, the professional will enter the taxpayer's information. To prevent the abuse of the system from being used by parties looking to obtain information that could be used for frauds against taxpayers, the system will not inform the tax professional if the information does not match the IRS records. However, only if the information does match the information for the taxpayer will the request be forwarded to the taxpayer's online account for their approval. The taxpayer will need to have or set up an online account with the IRS to use this system, going through a similar verification and authentication process as the tax professional went through to establish an account.[830]

In Step 3, the tax professional will enter the tax periods and tax matters to be covered by the authorization. The tax matters supported by the online system currently are:

- Form 1040 Income Tax
- Split Spousal Assessment or Form 8857 Innocent Spouse Relief
- Shared Responsibility Payment
- Shared Responsibility Payment—Split Spousal Assessment
- Civil Penalty (limited to periods of March, June, September, and December)[831]

Again, if the adviser wishes to obtain authorization for tax matters not listed, the tax adviser will need to file a paper authorization form.[832]

In Step 4 the tax professional will be able to review, edit, and submit the request.[833] In Step 5, the professional will receive a confirmation of submission if the request is successfully submitted. Until the taxpayer takes action on the request, the tax

[828] IRM 21.2.1.63.9
[829] IRM 21.2.1.63.11
[830] IRM 21.2.1.63.12
[831] IRM 21.2.1.63.13, 14
[832] IRM 21.2.1.63.14
[833] IRM 21.2.1.63.15

professional can cancel the request, but once the taxpayer approves or rejects the request, the professional will no longer be able to cancel the request.[834]

The tax professional is advised at this point to contact the taxpayer to advise them they need to log into their IRS online account and act on the request.[835] If the taxpayer approves the request, the authorization will show in the tax professional's authorization list as approved, while if the taxpayer rejects the request, it will be removed from the authorization list, and the professional will not be able to review the status.[836]

However, the IRM notes that an approved request may not be immediately added to the tax professional's approved list:

> If the taxpayer approves the request and it goes into a "processing" status, meaning it will attempt to be processed in the next 48 hours, it will be removed from the tax professional's list. The item will be removed from their list because the tax professional can no longer cancel it, and it is not written to CAF. If this authorization is later processed to the CAF database, it will show as Approved in the tax professional's Authorizations table. The tax professional should contact the taxpayer regarding any questions or concerns as they apply to the status of a request that they can't view.[837]

A withdrawal of representation cannot be processed on this system:

> Tax Pro Account does not allow for withdrawing or revoking, at this time. Cancel is not the same as withdraw. Cancel is the functionality used for the tax professional to delete or remove a request they have initiated for the taxpayer to sign. Once signed and processed, the request must follow the same revoke or withdraw guidelines as a paper Form 2848 or Form 8821. The person wanting to revoke or withdraw must print a copy of the authorization and submit it following the Form 2848 or Form 8821 instructions for revoke or withdraw.[838]

Special limits apply to multiple requests by a professional on the same day:

> Tax Pro Account has the ability for the tax professional to cancel any requests that they don't want the taxpayer to approve. However, if the taxpayer approves a request today and is then presented with another request, for the same tax professional, with at least one of the same tax periods and tax matters that they have already approved today, the

[834] IRM 21.2.1.63.16
[835] IRM 21.2.1.63.16
[836] IRM 21.2.1.63.17, 18
[837] IRM 21.2.1.63.19
[838] IRM 21.2.1.63.21

> request will fail to write to CAF. The new request for the same tax professional will be able to be signed and processed on a future date.[839]

If multiple representatives are to be appointed via this system, the following special rules apply:

- Each third-party must complete their own authorization request and submit it to the taxpayer's IRS online account, following the guidance above.
- The taxpayer must sign all of the online authorization requests on the same day.
- Only two third parties can receive copies of IRS notices and communications for each authorization type. If the taxpayer attempts to approve more than two to receive notices, any request after the second one, will fail to write to the CAF.[840]

SECTION: 6651
TAXPAYER HIT WITH LATE FILING PENALTY WHEN ACCOUNTING FIRM SUBMITS RETURN SECONDS AFTER THE FILING DEADLINE

Citation: Padda *v.* Commissioner, TC Memo 2020-154, 11/16/20

The Tax Court found that a taxpayer did not reasonably rely on a CPA retained to timely file his tax return in the case of *Padda v. Commissioner*, TC Memo 2020-154.[841] This was true even though the CPA submitted the return seconds after the clock ticked past midnight on October 15, 2013.

The Court described the events leading to the late filing of the taxpayers' return as follows:

> Padda and Kane's 2012 federal individual income tax return was due October 15, 2013. On October 15, 2013, Padda and Kane signed IRS Form 8879, "IRS e-file Signature Authorization" to authorize Ehrenreich's accounting firm to electronically file their 2012 Form 1040, "U.S. Individual Income Tax Return". On October 15, 2013, Ehrenreich's accounting firm was electronically filing several tax returns just before midnight. Ehrenreich's accounting firm created an electronic version of Padda and Kane's return on October 15, 2013, at

[839] IRM 21.2.1.63.22

[840] IRM 21.2.1.63.23

[841] *Padda v. Commissioner*, TC Memo 2020-154, November 16, 2020, https://www.ustaxcourt.gov/UstcInOp2/OpinionViewer.aspx?ID=12359, (retrieved November 17, 2020)

> 11:59 p.m. It transmitted the electronic version to the IRS on October 16, 2013, at 12 a.m. On October 16, 2013, the IRS rejected the return as a duplicate submission. Ehrenreich's accounting firm electronically re-sent the return on October 25, 2013, and it was received and accepted by the IRS the same day.[842]

At trial, the taxpayer and the IRS stipulated that the return was filed on October 25, 2013. The taxpayers claimed that they shouldn't be held responsible for the late filing because the CPA firm was responsible for the late submission.[843]

We've before discussed the general rule that a taxpayer cannot rely upon the actions of a third party for timely filing,[844] but rather must demonstrate that the taxpayer exercised reasonable care and prudence but was unable to timely file.[845]

The taxpayers described their actions as follows:

> Padda and Kane argue that the reason that their 2012 return was filed late was that (1) Ehrenreich's accounting firm pressed a button only a few seconds late, (2) they relied on Ehrenreich's accounting firm to timely file the return, and (3) they themselves could not have pressed the button to timely file the return.[846]

The Tax Court rejected their defense, both because ultimately they were attempting to delegate timely filing to a third party, but also because even if that were allowed, it would have been unreasonable to have relied on the firm to file timely in this case based on their previous experience with this accounting firm:

> Even if sometimes it might be reasonable for a taxpayer to rely on his or her accountant to timely file his or her returns (contrary to the caselaw), it was not reasonable in this particular case for Padda and Kane to rely on Ehrenreich's firm to timely file their return. Padda and Kane have relied on Ehrenreich's firm to file their returns every year since at least 2006. And every year since then, except for 2011, their return was filed late. Yet, they have continued to use Ehrenreich's firm to file their return year after year. Padda and Kane's failure to ensure that Ehrenreich's firm timely filed their 2012 return demonstrates a lack of ordinary business care, particularly in the light of the firm's history of delinquent filings.[847]

[842] *Padda v. Commissioner*, TC Memo 2020-154, pp.8-9
[843] *Padda v. Commissioner*, TC Memo 2020-154, p. 22
[844] *United States v. Boyle*, 469 US 241 (1985)
[845] Reg. §301.6651-1
[846] *Padda v. Commissioner*, TC Memo 2020-154, pp. 22-23
[847] *Padda v. Commissioner*, TC Memo 2020-154, p. 23

SECTION: 7502
TAXPAYERS NOT ALLOWED TO PROVIDE OTHER PROOF OF TIMELY MAILING WHEN USPS FAILED TO PLACE A POSTMARK ON THEIR CLAIM FOR REFUND

Citation: McCaffery v. United States, Case No. 1:19-CV-01112, US Court of Federal Claims, 8/9/21

In holding that the taxpayers in the case of *McCaffery v. United States*[848] had failed to prove their claim for refund was filed timely, the US Court of Federal Claims decision took the position that the US Tax Court had developed a method of showing timely filing for an envelope lacking a postmark that is at odds with the Internal Revenue Code.

The Court described the facts of this case as follows:

> Plaintiffs filed their federal income tax return for the 2013 tax year on April 15, 2014 with a total tax liability of $70,977. Compl. ¶¶ 6-7; Def.'s App. B at B-1-B-2 (ECF 11-1). In 2017, Plaintiffs filed an amended tax return claiming an overpayment of $69,080 for the 2013 tax year and requesting a refund in that amount. Compl. ¶ 8; Def.'s Mot. to Dismiss at 3; Def.'s App. B at B-15, B-17. The parties agree (and it appears to the Court) that the deadline for claiming an overpayment was April 18, 2017. Def.'s Mot. to Dismiss at 5; Pls.' Opp. at 1, 3.4 But the IRS noted the receipt date of Plaintiffs' amended return as April 24, 2017 — six days later.[849]

The IRS did not keep a copy of the envelope in which the return was mailed, but the agency did have a scanned image of the envelope. The opinion describes the image as follows:

> The image has Plaintiffs' surname and address handwritten on the top left, the IRS's address centered, and four postage stamps in the top right corner. Each stamp bears the same two lines of text: "US POSTAGE $0.49" and "SOLD APR [ ] FIRST CLASS."). Id. The bottom-right stamp appears to read "SOLD APR 17, 2017 FIRST CLASS," but the exact dates on the others are illegible. Id. The envelope bears the partly legible date "04/24/201[ ]" near the bottom

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[848] *McCaffery v. United States*, Case No. 1:19-CV-01112, US Court of Federal Claims, August 9, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/court-holds-return-wasn%25e2%2580%2599t-timely-filed%253b-refund-suit-dismissed/7754m (retrieved August 10, 2021)

[849] *McCaffery v. United States*, Case No. 1:19-CV-01112, US Court of Federal Claims, August 9, 2021

> right, and an alphanumerical sequence — "09B 030" — across the stamps along the right edge. Several dots and lines appear near the middle of the top edge of the envelope, but they do not form any distinct characters, shapes, or images, and there is no way to tell how they were made.[850]

The IRS disallowed the claim as not timely filed, noting:

> "The received date on your return is Apr. 24, 2017. The last day to file a timely claim or return for tax year 2013 was Apr. 15, 2017 [sic]. We can't allow your claim or return because the received date isn't on or before the deadline." Pls.' Ex. B (ECF 1-1).[851]

As a taxpayer must first file a timely claim for refund before being able to bring suit for a refund in the US Court of Federal Claims, the IRS argued when the taxpayers filed suit in the case that the Court had to dismiss the case for lack of subject matter jurisdiction. As the parties agreed, the only issue was whether the taxpayers could show timeliness under the rules for mailing a document to the IRS:

> The parties do not dispute that the Plaintiff's refund application was delivered to the IRS after the April 18, 2017 actual-delivery deadline. Given that this Court lacks jurisdiction over tax refund claims that are not timely presented to the IRS, see *Dalm*, 494 U.S. at 602, the issue is whether Plaintiffs have established timeliness under the deemed delivery rule.[852]

The Court found that the envelope clearly lacked a postmark, and the taxpayers had not used certified or registered mail (where the date stamped on the receipt by a USPS employee would establish a postmark date). Thus, the issue was if there was a way to show timely filing of an envelope that lacked the postmark.

The taxpayers provided evidence other than a postmark or certified or registered mail receipt to show the document was mailed on April 17, 2021. But the Court found it could not consider such evidence:

> But on the plain text of section 7502, the deemed delivery rule only applies if a postmark or equivalent marking was made: The date of the postmark is what matters, not the date of the mailing. I.R.C. § 7502(a) ("[T]he date of the United States postmark stamped on the cover in which such return, claim, statement, or another document, or payment, is mailed shall be deemed to be the date of delivery[.]").

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> Similarly, the regulations provide for extrinsic evidence only to prove the contents of an illegible postmark, not to prove the time of mailing when there was no postmark. 26 C.F.R. § 301.7502-1 ("If the postmark on the envelope is made by the U.S. Postal Service ***but is not legible***, the person who is required to file the document or make the payment has the burden of proving the date that the postmark ***was made***.") (emphasis added). As noted above, exceptions to a statutory requirement should generally be treated as exclusive. Without even an illegible postmark, the deemed delivery rule does not apply, and extrinsic evidence about the date of mailing is beside the point. That leaves only the dispositive fact that the amended return was delivered to the IRS after the delivery deadline.[853]

But the taxpayers point to a series of cases from the United States Tax Court where such extrinsic evidence was deemed to show timely mailing in the absence of a postmark. The opinion lists those various cases the taxpayer was relying upon:

> They cite a line of cases from the Tax Court holding that extrinsic evidence as to timely mailing must be considered when an envelope contains no postmark at all. Pls.' Opp. at 5 (citing to *Sylvan v. Comm'r*, 65 T.C. 548 (1975); *Seely v. Comm'r*, 119 T.C.M. (CCH) 1031, 2020 WL 201751 (2020); *Williams v. Comm'r*, 117 T.C.M. (CCH) 1328, 2019 WL 2373552 (2019); *Blake v. Comm'r*, 94 T.C.M. (CCH) 51, 2007 WL 2011294 (2007); *Menard, Inc. v. Comm'r*, 41 T.C.M. (CCH) 1279, 1981 WL 10531 (1981); *Monasmith v. Comm'r*, 38 T.C.M. (CCH) 60, 1979 WL 3117 (1979); *Ruegsegger v. Comm'r*, 68 T.C. 463 (1977)).[854]

But in this decision, the Court argues that these cases are based on what the judge finds to be a significant error in the *Sylvan* decision:

> In that case, much like this one, the Tax Court confronted an envelope with no postmark that was delivered after a deadline. The court found a gap in the statute: "There is nothing at all in the statute or legislative history indicating what Congress intended where the postmark is illegible; where there is no postmark because the petition was inserted in a new postal cover when the original cover was damaged; or where no postmark is affixed due to oversight or malfunction of a machine." *Sylvan*, 65 T.C. at 552. "[I]n these circumstances," the court reasoned, its "task . . . is to ask what Congress would have intended on a point not presented to its mind, if the point had been present." *Id.* (quotes omitted). The court concluded, over a dissent, that extrinsic evidence

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> should be admitted to prove the date of mailing for purposes of the deemed delivery rule not only when a postmark is illegible, but where it is absent.[855]

The opinion begins an extended discussion about the issues it finds with the *Sylvan* decision. The first is to object to the claim that the law did not provide for a result if there was no postmark applied:

> That was erroneous for several reasons. To begin with, the Tax Court was mistaken that the Internal Revenue Code contains "nothing at all . . . indicating what Congress intended" in cases of absent postmarks. Id. Section 6511(a) contains a deadline, and section 7502 contains a deemed-delivery exception that is textually inapplicable when a postmark is missing. There is thus no gap to be filled; a late-received envelope lacking a postmark is simply untimely, whatever the extrinsic evidence might be. When a court treats circumstances covered by a general rule as falling into a gap, the court is not really "ask[ing] what Congress would have intended," *Sylvan*, 65 T.C. at 552, but presuming that the statute should say something different. See also Antonin Scalia & Bryan Garner, *Reading Law: The Interpretation of Legal Texts* 94 (2012) ("As Justice Louis Brandeis put the point: 'A casus omissus does not justify judicial legislation.' And Brandeis again: 'To supply omissions transcends the judicial function.'") (citing *Ebert v. Poston*, 266 U.S. 548, 554 (1925), and *Iselin v. United States*, 270 U.S. 245, 251 (1926)).[856]

In the Court's view, the law simply provided this document was not timely filed regardless of what evidence might otherwise be advanced to show the document was mailed on April 17.

The opinion also complained that the Tax Court was, effectively, creating additional provisions beyond those contained in the Treasury Regulations governing this provision:

> Besides, when *Sylvan* was decided, the Treasury had already promulgated the regulation providing for extrinsic evidence of the contents of illegible postmarks, but not absent ones. See *Republication*, 32 Fed. Reg. 15241, 15355 (Nov. 3, 1967); see also *Sylvan*, 65 T.C. at 560 (Drennen, J., dissenting) (noting that the regulations then in effect "provide[ ] that if the postmark on the envelope is not legible, the petitioner has the burden of proving the time when the postmark was made"). By sanctioning proof by extrinsic evidence in other

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> circumstances, the Tax Court merely created a new exception that neither Congress nor the administering agency authorized. That, too, is inappropriate: A judge should not "elaborate unprovided-for exceptions to a text, as Justice Blackmun noted while a circuit judge: 'If the Congress had intended to provide additional exceptions, it would have done so in clear language.'" Scalia & Garner, supra, at 93 (citing *Petteys v. Butler*, 367 F.2d 528, 538 (8th Cir. 1966) (Blackmun, J., dissenting)). Nor should a court assume that because a legislature provided relief from a general rule in one circumstance, similar relief should be applied in other circumstances. See *Easterbrook*, supra, at 541 ("Legislators seeking only to further the public interest may conclude that the provision of public rules should reach so far and no farther[.]")[857]

Thus, the Court of Federal Claims concludes that the missing postmark automatically means that the filing was late when it was not received by the IRS by the last date in the statute. Despite the fact that the result may seem harsh, the opinion concludes that it must follow the text of the statute:

> Yet the text controls. The Supreme Court recently addressed a strikingly similar situation in *Pereida v. Wilkinson*, which held that noncitizens challenging removal orders under the Immigration and Nationality Act have the burden of proving "all aspects of their eligibility" for relief. 141 S. Ct. 754, 758 (2021). Much like the McCafferys, the noncitizen facing removal in *Pereida* argued that under the Court's interpretation, some individuals entitled to relief might be unable to prove it "through no fault of [their] own," perhaps because of "poor state court record-keeping practices." *Id.* at 766. The Court answered that it was bound to the policy choice reflected in the statute: "It is hardly this Court's place to pick and choose among competing policy arguments like these along the way to selecting whatever outcome seems to us most congenial, efficient, or fair. Our license to interpret statutes does not include the power to engage in such freewheeling judicial policymaking." *Id.* at 766-67; see also *BP P.L.C. v. Mayor & City Council of Baltimore*, 141 S. Ct. 1532, 1542 (2021) (observing that a court's task "is to discern and apply the law's plain meaning as faithfully as we can, not 'to assess the consequences of each approach and adopt the one that produces the least mischief'") (quoting *Lewis v. Chicago*, 560 U.S. 205, 217 (2010)). The same is true here.[858]

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